PRACTICAL DIRECTORSHIP

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A GUIDE TO THE DUTIES OF A COMPANY DIRECTOR

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PREFACE

In the preparation of this volume on "Practical Directorship," the authors have not been unmindful of the fact that numerous handbooks for the guidance of directors have been published in the past—each with a purpose to fulfil and fulfilling it admirably. In the majority of cases this purpose has been the explanation of the statutory obligations surrounding the office of director, warning him of the penalties provided in the Companies Acts for inefficient directorship. This present volume deals but briefly with the legal duties of directors; the aim of the authors has been to set out the commercial duties attaching to efficient directorship as distinct from the statutory duties, to explain practical directorship as distinct from sustained effort to obey the law, and to guide the inexperienced director in the principles of company finance and administration.

The work is addressed to the director who has hitherto devoted his attention to those sides of a company's business which are but little concerned with actual control, e.g. production, sales, advertising, and so on. It is also addressed to gentlemen of leisure, retired naval and military officers and others, who desire to occupy their time and capital in the direction of joint stock enterprise. It is hoped that this volume, which explains the principles underlying the duty of a director, will give them a working knowledge of the matters calling for their attention, and will point the way to the practice of directorship and assist them to guard against the present-day policy of *laissez faire* so common on many boards.

It is the authors' earnest desire that the work will also prove of value to directors who have had long experience on the boards of companies, but who have nevertheless not fully appreciated the immense advantages which can accrue to a company under practical direction. It will be found that the text deals with the direction of manufacturing companies rather than with the direction of non-manufacturing companies. This has been found to be unavoidable. It became necessary to choose between following the particular duties of a director in a manufacturing company, and dealing in broad outline with the director's duty in all classes of business.

The latter course was rejected as it defeated any efforts to preserve continuity. Further, it had the additional disadvantage of reducing the work to a superficial summary of specialized duties, which could not be treated adequately within the limits of the present volume. At the same time every effort has been made to render the text applicable to most businesses ; and the director of such companies as the colliery company, the shipping company and even the insurance company should have no difficulty in applying the greater part of the book to his own particular purpose.

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PART I
The Director and Administration

CHAPTER I

THE QUALITIES OF DIRECTORSHIP

THE quality or office of directorship differs from the quality of the professions and commercial callings in the very important point that it is what each and every holder makes it. It is not bounded by any set code prescribing duties and is subject to no control beyond that provided by the Companies Acts, 1908-17. It follows, therefore, that perfunctory attention to a company's business, even if limited to the task of endorsing cheques for fees in respect of theoretical services, is termed "directorship" in business terminology just as much as the same term is correctly applied to real direction, real control and practical directorship.

Directors have been variously described as managers, managing partners, trustees and by a hundred and one descriptions differing but slightly in their import. In any consideration of the full duty of a director no term is more apt than that of trustee. The term is not used to imply that a director is a trustee in the strict legal sense of the word, but that he is holding his post with the confidence of the proprietors and that he has their trust to conserve and

guard; it is used to indicate that the office is even more important than that of "managing partner appointed to fill that post by a mutual arrangement between all the shareholders." (*Automatic Self-Cleansing Filter Company* v. *Cunningham*, 1906). Statute law and legal opinions have rarely impressed the office of directorship with a status much higher than that of agency and this opinion provides a striking comparison between the present conception of directorship and the full denotation of trusteeship. There has been an unmistakable movement during recent years to render this difference between the two classes of responsibility less marked, but unfortunately the movement has been directed towards the alleviation of the burden on the trustee. Such a step is retrograde and is to be deplored. If the difference is to be adjusted then surely it should be accomplished by rendering the responsibility of directors in respect of a company's property, real as well as apparent.

Nominal and Active Directors.

It is difficult to give a definition of the distinction between nominal and active directorship. As the day of the nominal director is drawing to a close, however, an elaboration of the distinction is scarcely necessary. In the past the uneconomic practice of paying large fees to directors in return for no service beyond the use of their name has flourished extensively. The cynic will aver that where such payments are made for mythical service, the rest of the company and its business are equally mysterious. It is certain that expenditure of this nature cannot assist a company in days of prosperity or salve it in times of adversity. It cannot be considered as wages of management, payment for labour, or reward for organization, and were it not that the companies

concerned had at least one guiding spirit controlling their destinies, nothing could save them from fulfilling the prophecy of Adam Smith that joint stock enterprise would never succeed on account of the lack of interest on the part of those responsible for the care of the entrusted funds. Adam Smith condemned in his day the very same principle which now permits some directors' duties to commence and end with the permission to use their name on the prospectus and statutory returns.

Immunity of Nominal Directors.

It is regrettable that legislation is not framed to exclude the abuse of nominal directorship. When a company fails and compulsory liquidation is set afoot, penalties for neglect on the part of nominal directors are illusive and rarely applied. Section 215[1] of the Act certainly provides for misfeasance proceedings against the officers, but only in the event of misapplication or wrongful retention of the company's funds and an action is not commenced unless it can be shown that there has been a breach of trust resulting in pecuniary loss to the company. Negligence in the case of nominal directors is negative negligence and the onus of proof, a difficult one, lies on the party bringing the charge. Moreover, a director is not legally liable for misfeasances committed by his fellow directors at meetings at which he was not present; neither is he liable for omitting to attend those meetings. In practically every case the nominal director escapes unscathed for neglect of duty, and the records of the unfortunate companies whose untimely end he has contributed to hasten, are consigned to oblivion quietly and unostentatiously.

[1] For the text of this section of the Companies Act, and of other sections or clauses quoted in later chapters, see the Appendix on page 227.

The Aim for a Higher Status.

It follows that any effort towards the improvement of the status of directorship can only be individual. Such efforts, however, are more likely to attain the desired object than either legislation or combination for advancement in the form of a learned society. It may be thought that the status is already high. It is true that the director, newly fledged as well as long experienced, is endowed with a species of authority immediately upon appointment and is treated with extreme adulation by the staff of the company he assists to direct. How far this adulation is sincere and how far induced by the trend of human nature must be a question of degree, affected by other factors.

It is well, however, for the new director to free himself from the idea that he is, *ipso facto*, a giant of finance. He should endeavour to see himself as others—outside his company—see him. It would be well to recall from time to time the remarks of Mr. Justice Coleridge in Dr. Farncombe's action against Sperlings: "I derived some consolation from the reflection that these giants of finance, upon closer investigation, dwindle down to very ordinary proportions. They usually transact business with each other involving millions in a most unbusinesslike way." Remarks similar to these occur with unfailing regularity in the course of every case, civil and criminal, brought before the courts. A study of the judgments in such cases as *Lagunas Nitrate Co.* v. *Lagunas Syndicate*, 1899, *Oxford Benefit Building Society*, 1887, and *Coventry and Dixon's case*, 1880, will prove clearly that the appointment to a directorship will not make the holder a thorough *chevalier d'industrie* automatically. The office is one to be approached cautiously and with a sense of responsibility not unmixed with a certain degree of humility.

Efficiency in Directorship.

There can be no doubt that efficiency in directorship will be achieved only when a standard of training in the principles of business comes to be regarded as equally essential in the case of a director before appointment as it is a condition precedent to the appointment of any subordinate officer. It is not suggested that every director should submit himself to an elementary course in commercial procedure or pass through long periods of erudite study and numerous examinations. When it is remembered that the majority of directors are either men who have taken seats on boards after years spent in production or salesmanship, or men who have had long experience in the control of a sole trader's business, it is apparent that an extensive training in joint stock company control is impracticable. And yet in these cases, just as much as in the case of young men who assume directorships straight from school, there seems no reason why a standard of efficiency should not be expected of the heads of a business when such a condition is imperative in the case of every officer of the company of lower grade. The case of the young man direct from school is of greater importance than the other. It is unfortunate that "directorship" is marked down by parents as a profession for their offspring, requiring no exact qualification beyond a pecuniary one. Happily this practice, so rife during the immediate post-war period, is dying out. Nowadays such candidates wisely proceed to the board by way of the practical training required for the commerce degrees or submit themselves to a period of training in subordinate posts. There is no doubt that amateur directors are as much a menace to commercial prosperity as amateur auditors. Professor Dicksee, the eminent accountant, avers that whereas one inefficient doctor may

imperil the lives of but comparatively few people, the incompetence of an amateur auditor may encompass the ruin and entail the self-destruction of thousands. This stricture may be a little harsh in that connection, but it is not unduly strained when applied to the amateur director.

What Practical Directorship Means.

The keen director will then ask what practical directorship entails and what is expected of him in order that his company may feel the benefit of his services. In the first place he must be well acquainted with his legal responsibilities and obligations. As previously explained, it is not the purpose of this book to dilate on the legal points in detail, but sufficient explanation of the legal aspect of every duty will be given to enable the director to keep within the law, and moreover, to observe the spirit of each section of the company statute. On the practical side, every director should be able to appreciate the general principles of joint stock finance, he should know how to control the working capital of his company, understand the organization of its staff, be in a position to offer constructive criticism on finance and policy and be able to preserve a spirit of independence and a power of judging for himself. He should understand the principles of costing, taxation and organization, he must be acquainted with accounting principles and be able to read a balance sheet, grasp the import of periodical returns, and know to whom he must turn for information on any point affecting the welfare of the concern whose destiny is committed to his charge.

The Application of Knowledge.

The ability to apply the principles of practical

directorship must vary in individual cases, but the need of every company for whole-hearted application remains constant. The director must therefore ensure that his company receives the benefit of his direction as well as his control. In later chapters will be found explanations of the manner in which financial data are usually prepared, together with hints concerning the information conveyed. The conclusions drawn by each director may be applied either through the medium of board meetings or by personal contact with the company's officers. Unless the knowledge gained is put to practical use, then the control exercised by the director is nominal only and does not constitute direction. It is obviously unfair to leave the formulation of policy to the officers, and that is what occurs when the members of a board grasp the import of information laid before them, but either neglect or shrink from the application of their knowledge. This need for real direction is equally important whether the decisions of a board are carried out by a managing director or by the company's officers. Unless the board expresses its views on the actual conduct and progress of the business its meetings resolve into a series of reports of the doings of one man who receives no real assistance and is left to his own devices. This is one instance of excessive delegation of authority and is one of the reasons why many companies proceed along a path mapped out by one man, until the peaceful security into which it has been lulled is rudely shattered by some incident of greater or less importance revealing a less happy state of affairs than was imagined. Such occurrences can be obviated only by whole-hearted interest and direction by each and every member of the board. If any director is content to acquiesce in the decisions of one or more strong (yet perhaps misguided) spirits,

then he becomes a nonentity whose personal immunity from statutory penalties is seriously threatened. He is certainly not fitted to guide any company.

The remarks of Mr. Alfred Salmon, the Chairman of J. Lyons & Co., Ltd., on one-man control may be cited with advantage at this point—

> I have a great dread of a large institution with a great deal of money involved where the whole of the activities depend very largely upon the inventive genius of one individual.

It must be realized that practical direction calls for the devotion of much time to the real control of the company's business in addition to a sound knowledge of the principles governing joint stock trading. Not only must the director be well acquainted with the matters arising at any particular meeting, but he must have his finger on the pulse of the business at all times. If his other interests are so multifarious that he cannot find time to keep himself informed of every matter of import concerning his trust then in all honesty he should not retain his seat.

Multiple Directorships.

Except in the case of the managing director or managing directors, the office of director is rarely one calling for full time services. It is natural then that most part time directors accept seats on more than one board. As long as this practice does not preclude the devotion of sufficient time to each company as is set out above, little can be said against it. It is inadvisable, however, for any recruit to the ranks of directors to join in the competition for holding the record number of appointments duly recorded in the annual issue of " Skinner." To term this aspect of the practice an abuse is perhaps too hard a term, but it is indeed difficult to believe that the division of a

director's attention among fifty companies (and instances of such multiple appointments exist) can be conducive to the best interests of each and every company whose assets are entrusted to his care. It goes without saying that the man who has his finger on the pulse of everyone is little short of a genius endowed with a brain which any man would covet.

Weighing the Responsibilities.

Before accepting a post on any board it is everyone's bounden duty to weigh thoroughly the responsibilities involved. If the company is already established then its past history must be known to the intending director. If he is assuming a seat on the inception of the company then his responsibility dates from the time he is either named a director by the signatories to the Memorandum of Association, elected by the shareholders, or appointed to his post by the Articles themselves. If he is appointed by the Articles then he must file with the Registrar of Joint Stock Companies a consent in writing to act as a director and either sign the Memorandum agreeing to take up shares at least to the number required for qualification or file a contract with the Registrar stating that he will take and pay for the required number of shares. These duties are prescribed by Sec. 72 of the Act of 1908, which further forbids the publication of a prospectus naming a director who has not previously carried out these provisions. It follows that the responsibility of the director who joins a board on the incorporation of the company commences immediately, and he must consider the burden resting upon him from the day the prospectus is handed to him for approval. His trust will take effect from the time the public are invited to join as shareholders; his responsibility will continue throughout

the time he remains on the board and for certain purposes even after the dissolution of the company or after his own resignation or disqualification.

The responsibility should not be regarded as a duty bounded by the letter of the statute but as a duty which can be carried out successfully if carried out conscientiously. It will appear from succeeding chapters that some duties may be legally performed in a manner not consistent with the spirit of the law. Certain provisions are made for the protection of the shareholders which may be avoided by devious and yet legal manipulation. It is possible to ride rough shod over Sec. 81, which seeks to ensure that the public shall receive specific information in prospectuses. It is not unknown to practise devices for rendering nugatory Sec. 84, which provides remedies for misled subscribers. Numerous instances could be given of these loopholes in the Acts, but their iteration will only be resorted to for the purpose of emphasizing the lessons this book is intended to convey—that successful directorship is practical directorship and that practical directorship is incompatible with any attempt, no matter how apparently justifiable, to drive a coach and four through any section of an Act which has for its purpose the protection of the public who elect trustees and place their capital under their charge and honour them with their unqualified confidence. The successful director then will be the one who regards his duty in this light and who remembers his stewardship when he is in doubt as to the extent to which he should, for instance, disclose his interest in property to be purchased (Sec. 81), or when he is tempted to follow the now common yet illegal practice of taking qualification shares from a promoter and executing blank transfers. He will not sanction the inclusion of statistical fallacies in prospectuses

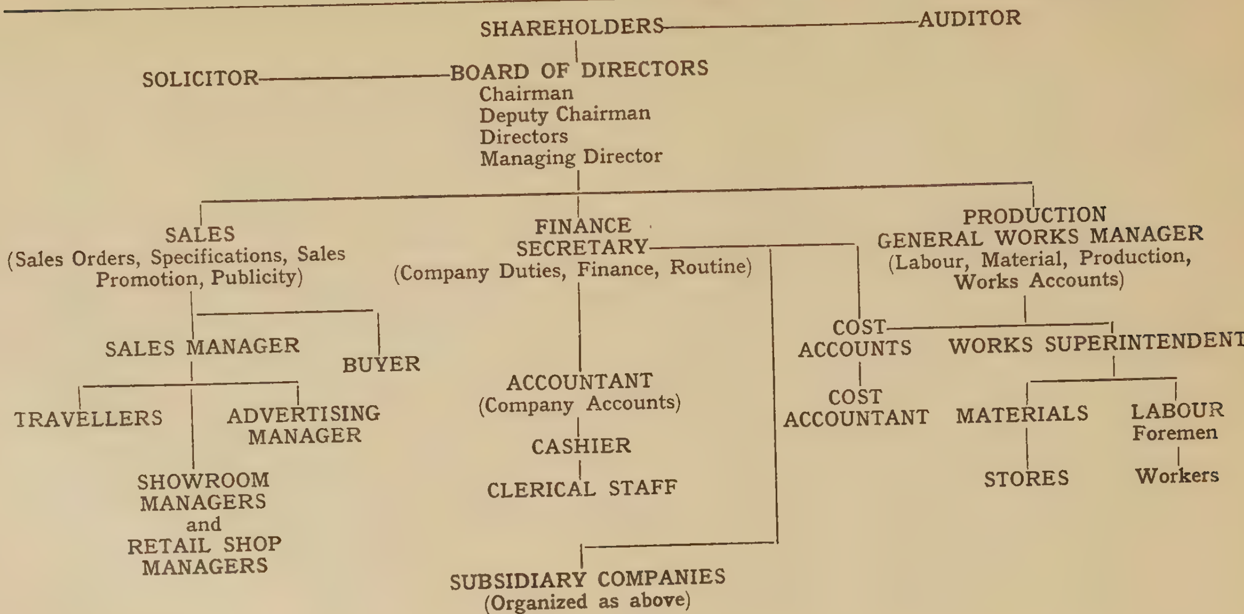
and will see that he is not a party to any empiricism in appeals to the public for money. The practical director will be, in word and in deed, the warden of his employers' chattels and the guardian of their every interest.

CHAPTER II

THE ORGANIZATION OF JOINT STOCK COMPANIES

THE organization of the staff of joint stock companies differs from that applicable to partnership businesses and sole trading concerns in so many ways that it is necessary to explain in detail the principles followed. Different organization is followed in different businesses but a knowledge of the usual channels through which authority is delegated step by step from a board of directors will enable the reader to apply the principles to any class of trade. In the first place the directors, and not the subordinate officers, are responsible to the shareholders for every matter affecting their property. It is true that the secretary is liable to penalties for omissions of duty under the Acts, and that all officers, including auditors, are liable for the contravention of the sections of the Acts affecting them. Nevertheless the board is in fact the accounting party to the shareholders and not the managing director, the secretary, the accountant, the auditor, or the solicitor. Authority is therefore traced downwards from the directors in every case. An outline of the channels of delegation is given below. It represents the chain of authority of a manufacturing and selling company owning subsidiary companies and from its outline the director may see at a glance exactly how each division of the business is allocated to a specific department. If, for example, he wishes to acquire certain information concerning new machinery, he will see that it must be obtained from the works manager either direct or via the secretary or managing director.

DELEGATION OF AUTHORITY IN A MANUFACTURING COMPANY



The Board of Directors.

The organization of a Board of Directors does not vary greatly in English companies. There is usually a chairman, who is supported by a deputy chairman. The orders of the board are usually put into effect by a managing director who spends his whole time with the company. The directors, whether ordinary members of the board or whether acting as chairman or managing director, are appointed in various ways, depending to a great extent on the Articles of Association, which are rules for the internal government of a company. The Articles often provide that the first appointments shall be made by the signatories to the Memorandum or that the signatories themselves shall become the first directors, and that later vacancies shall be filled by the board subject to confirmation at a general meeting. The appointment is therefore entirely subject to the rules set down by the company itself for its own management, and it is quite possible to arrange that the directors shall have absolute power to recruit other directors to fill vacancies ; in that case the shareholders have no voice in the matter unless there exists such dissension on the board that new directors cannot be elected, in which case vacancies will be filled by the shareholders. On the other hand, the Articles may be framed in such a way that the shareholders only may appoint directors or that appointments made by the board shall be confirmed by the members at the next annual general meeting. It is the duty of every director to study the Articles of Association, and to ascertain whether his own appointment and the constitution of the board are valid. It is not sufficient to leave these matters to the company's solicitor or secretary.

With regard to qualification shares it must be observed that if the Articles are silent on the matter,

a director is under no obligation to take up more than one share. If the Articles stipulate that qualification shares must be acquired, and set forth the manner of acquiring them, then the directors must follow the exact provisions laid down by the Articles. In any case the shares must be acquired within two months of appointment (Sec. 73). It is a grave breach of trust on the part of a director to accept his qualification shares as a gift from a promoter or to put the shares at the disposal of a promoter by means of a blank transfer. This latter custom cannot be too rigidly condemned; it is an act in the nature of a misfeasance (*L. & S.W. Canal case*, 1911).

Other matters relating to the constitution of a board and its duties in the company's plan of administration will be dealt with in later chapters.

The Chairman, Deputy Chairman, and Managing Director.

The chairman and deputy chairman are ordinarily chosen by the directors from among their own number. The posts usually carry higher fees than those payable to the other members and in most cases the chairman is given a casting vote. On the matter of fees, it should be observed that no director is entitled to fees by a statutory right and that if he carries out duties for a time and resigns from the board, he has no right to payment *quantum meruit* if the Articles contain no provisions for the payment of fees. Whether directors are entitled to fees or not depends entirely on the Articles, for if the Articles are silent on the matter then any sum voted by the shareholders in general meeting is of the nature of a gratuity only. If the Articles do not provide for the payment of fees and the shareholders do not vote a gratuity then a director has no claim whatever to remuneration. The

position of the managing director is rather different. In his case there is usually an agreement for service under the seal of the company, providing for payment of a salary. The managing director in that case is an employee of the company with rights to remuneration in the terms of his contract.

Chairmanship and Continuity.

From time to time there arises a cry for "limited-period chairmanship" and every director should form his own opinion on the matter after taking into consideration all the circumstances peculiar to his own company. It is impossible to form any definite opinion on the matter until one has had an opportunity of gauging the acumen and efficiency of the chairman in power at the time. It is important, however, that the custom be kept in mind in order that its adoption may be suggested if the control of the board appears to be devolving into one-man administration to the evident detriment of the company's interests. The argument in favour of limited-period chairmanships is that it leads to increased efficiency. It is true that many insurance companies and banking houses follow the practice with undoubted success. As against this there is, of course, the case of the late Sir Edward Holden. One is often tempted to ask whether the Midland Bank would be in its position to-day if Sir Edward had held the office only during broken periods. That the bank grew from a tiny concern in one office to a place in the "Big Five" is perhaps the most striking tribute to continuous control one could find. In the case of industrial companies everything will depend on the circumstances. Generally speaking, it is advisable that continuity should be preserved on account of the difficulty which arises whenever a stranger chairman takes office, due to the fact that he

requires some months to acquire a knowledge of the company's business.

The Secretary.

The office of secretary is perhaps the most onerous and important in any company organization. In some companies the secretary's duties are segregated from pure accountancy work and the latter is delegated to an accountant. A distinction between an accountant and an auditor, which will be explained at greater length under the heading "Auditors," must be noted by the director. It is, however, frequently the custom for the secretary to combine the duties of accountant with his own. This is due in no small measure to the training in accountancy prescribed for members of the Chartered Institute of Secretaries, a body which has successfully raised the professional status of the secretary by insistence on the acquirement of full knowledge of secretarial and accounting work. Members of the principal accountancy bodies, on the other hand, also receive adequate training in secretarial practice. Whether or not this practice of combining the two offices obtains in his company must be ascertained by the director on joining the board.

It will not be out of place to emphasize the dignity and importance attaching to the office of secretary at this point. The secretary is the agent of the company through whom practically all the important business of the company is carried out. The Articles frequently provide that all deeds sealed by the company shall be countersigned by him, and it is his duty to bring all matters of import before the board, to deal with their orders, and to control the clerical work and staff. It should be the endeavour of the director to preserve the dignity of the secretary's post

and to avoid belittling his authority or control in any way. The whole of the clerical staff should be subject to this officer in whose discretion all rules relating to the conduct of subordinates should remain. It is inadvisable, for instance, for a managing director to arrange that his own typist or clerk should be placed outside the jurisdiction of the secretary. If the secretary sees fit to formulate instructions as to the times of attendance and similar matters which do not quite coincide with the views of certain directors then the matter should be rectified by a private talk with the secretary, who can adjust the rules without loss of dignity. It is a deplorable practice for a director to lessen the authority of the company's most important officer in any way.

It will be observed from the chart that the secretary forms the link not only between his own accounting offices and the board but also between the works, the sales department, the purchasing department and the subsidiary companies. Strictly speaking, therefore, all enquiries should be directed to the secretary who will obtain the requisite information from the proper sources. In practice it will usually be found possible and satisfactory to proceed to the heads of departments direct.

The responsibilities of the secretary for clerical work in the company's factories will vary according to circumstances. It is advisable to leave him in charge of all clerical staff whether employed in the works offices or in the central accounting office. The reason for this principle is that the works manager should be free to concentrate his attention on production instead of having to spend considerable time in the supervision of clerical work. In any case the works clerical staff should be subject to the works manager for discipline. It is usual, moreover, for

the secretary to pass his directions as to accounting returns and requirements through the works manager. Whatever arrangements of detail are found necessary for co-ordination between the factory and head office accounting, the principle of control by the chief officer of the company, the secretary, should be observed. He alone is capable of judging the efficiency of the clerical staff and of economizing in, or adding to, the expenditure under this heading.

The Sales Department.

The sales department is controlled by a sales manager, who concentrates entirely on the disposal of the company's products, conducts its advertising and governs its salesmen. The sales manager directs the company's travellers and showroom managers. He plans the travellers' journeys and receives from them at frequent intervals reports concerning their work. The sales department does not keep any books of account. The ledgers relating to customers' accounts are kept in the office under the secretary or accountant and liaison is therefore necessary between the two departments. All orders from customers are passed through the accounts office immediately upon receipt and marked by the secretary's staff with a note to the sales department as to the state of the customer's account or as to his known status. The sales department then approves the order and passes it forward to the stores for execution or files it until the customer settles his previous account or provides cash against a *pro forma* invoice. Another matter demands the maintenance of co-operation between the accounts department and the sales department, namely, the provision of lists of outstanding accounts, which can be carried by the travellers on their journeys, assisting them in judging the

advisability or otherwise of booking large orders from delinquent retailers, and aiding the accounts department in the collection of old accounts.

It will assist the director to know that the sales department should be in a position to give the sales results for different territories, for different classes of goods, and from different travellers, while the accounts department should give the total amount of goods invoiced from day to day, or from month to month, and the amount of goods not paid for at any date. This matter is referred to in a later chapter, but it is introduced at this point to draw attention to the real function of the sales department and to emphasize that it is not directly concerned with any financial records or accounting.

The Purchasing Department.

The purchasing department is controlled by a head buyer. It is his duty to supervise all the purchases of his company and to direct the energies of the subordinate buyers. The importance of this department varies according to the type of business. A merchanting company importing finished goods or buying finished goods from manufacturers at home for resale will have a purchasing department whose chief will be in a way subordinate to the sales manager. The sales manager in such a business often sells his goods before they have been purchased, and orders from the purchasing department the goods he requires for orders. Purchases for stock are usually arranged at conferences between the sales manager, managing director and head buyer. In the case of a manufacturing business, however, the procedure is rather the reverse. The board or the managing director having mapped out a production policy for the factory, it is the duty of the purchasing department to buy

the raw material or finished parts required by the programme adopted. Goods for manufacture are then taken into store under the control of the stores manager or chief store keeper and issued to the works against requisition.

The Works Manager.

The works manager is subject to the board through the managing director. Matters of routine are usually carried out through the secretary. His production policy is dictated to him by the board as soon as they have formulated a programme based on the reports of the sales department and the finance department in manner to be explained in a later portion of this book. It is essential that the director should have a sound knowledge of the company's products and processes of manufacture. For this reason he will be well advised to pay frequent visits to the works, studying the production possibilities and limitations. Much time and money is lost by the enforcing of a policy on the works manager which is incapable of economic fulfilment. Directors should be acquainted with the type of plant employed, know its life and functions, and understand absolutely the conditions of labour existing in each factory. Unless this knowledge is acquired it is impossible to comment to advantage on the manufacturing accounts when they are laid before the board, or to furnish practical advice on such matters of policy as depreciation, rates of pay, etc.

Subsidiary Companies.

When a parent company owns as much of the issued share capital of other companies as can legally be held by one individual then the organization of those subsidiaries will usually follow that applied

to the chief company. Variations suited to the particular requirements of each will, of course, be introduced, and when practicable, the clerical work will be committed to the parent company's staff, thus effecting great economies.

With regard to the directors of subsidiary companies, it is customary to appoint a board of nominees for each company, the nominees usually being members of the parent company's own board. Again, it is usual to co-opt officials of the subsidiary or its former managers as additional directors; thus when a subsidiary which was formerly conducted under partnership guidance is converted into a company and absorbed by a holding company, it will frequently be found that the former partners have been retained as directors of the subsidiary company in addition to a majority of nominee directors by the main body. The case of the subsidiary company not wholly owned is a difficult one and will be discussed separately. In the case of the subsidiaries wholly owned, however, it is possible to give some general advice as to the director's conduct in connection therewith.

The practice of placing members of the parent board in charge of subsidiaries is a good one provided the directors appointed realize the dual nature of their trust. It sometimes happens, however, that directors placed in charge of subsidiaries fail to realize that the policy of the smaller companies must accord with the policy of the parent company. It is useless, for instance, to embark upon heavy expenditure in order to ensure the success of the little concern over which they have greater control, if foresight plainly reveals that the capital burden will fall heavily on the parent company. The satisfaction of declaring a paper dividend from the subsidiary to the parent

company should be ignored if the ultimate benefit of the whole concern is likely to be reduced by such a course. This difficulty arises more frequently in cases where the boards of subsidiaries are not composed entirely of members of the parent board. The outside directors naturally desire to present as favourable a report of their work as possible and they are apt to resent the imposition of a policy which, though benefiting the parent company, may do so at the expense of the subsidiary. In order to obviate this trouble it is recommended that no outside directors be appointed to the boards of the companies wholly owned.

If the practice is at all possible, it is further recommended that all members of the parent board be appointed to seats on the boards of the subsidiary companies. The reason for this may not be quite clear and a word of explanation may not be out of place. It is a maxim of successful direction that all actual execution should be delegated. Unfortunately, the dividing line between direction and execution is not always recognized and some directors are apt to delegate duties which should be carried out by themselves. The existence of a subsidiary board is a great temptation to excessive delegation whenever the directors having power to delegate do not happen to have seats on the smaller concern's board. Matters requiring momentous decisions are brought forward by the technical officers of the subsidiary company and the responsibility is shirked by the simple expedient of referring the question to the board of the subsidiary, with whose deliberations the chief directors need not be troubled. The same objection may be raised to the unbusinesslike method of referring matters of policy to committees of subordinate officers. It may be advanced that this practice is sound on account of the fact that the business of the

subsidiary is often quite alien to that of the parent company and that the principal directors have no practical knowledge of the manufactures or processes of the subsidiaries. This is not an argument against the practice of making the directors of one company members of the boards of all the companies ; it is an argument against the practice of forming huge amalgamations of companies between the products of which there is no connection.

The experience of the past few years has proved conclusively that combines realize the benefits for which they are organized only when the business of the subsidiary is identical with or ancillary to the main business. The amalgamation of the engineering company with the shipping company, the plantation company and the boot-making company rarely succeeds. Oncost saving is not effected, for the staff of the various companies know nothing of the business of the others in the group. Huge headquarters and composite boards are formed and complete disintegration sets in after the outlay of no inconsiderable portion of the main company's liquid assets. The only cases in which amalgamations succeed are those in which the various boards and officers are in some measure cognizant of the practical side of all the associated businesses. The absorption of companies producing raw materials for the main manufacture is not open to the same condemnation, for the soap manufacturer, for instance, must always have some practical knowledge of the merchanting of the oils, derived from his previous dealings with independent suppliers. It is only the case of the shoemaker refusing to stick to his last that leads to disaster. This matter has been dealt with at some length in order to illustrate the difficulties besetting combines when the divergence between the nature of goods

manufactured by the constituent companies is such as to preclude the appointment of all the chief directors to seats on the boards of all the subsidiaries.

Subsidiaries Not Wholly Owned.

Directors must be particularly careful to differentiate between the subsidiary wholly owned and the subsidiary in which the parent company owns the majority of the shares. In the latter case it is undesirable to control the policy of the subsidiary without full regard to the rights of outside shareholders. The will of the majority cannot be forced upon the minority to the detriment of the latter's interest.

This matter is one of extreme importance and it is essential that the director should see the whole point in correct perspective.

It may be accepted firstly that the internal management of a company concerns none but the shareholders. As a general principle then it is in order for the majority to dictate the policy of the company. This first principle will be fully appreciated by the reader if he will turn to the case of *Foss* v. *Harbottle*, a case with which every director should be acquainted, and follow the exceptions, or at least, the rulings which restrain a majority from assuming complete control. The combined effect of these rulings amounts to forbidding the majority imposing upon, defrauding or causing loss to the minority, but the danger of injuring the minority *without intent to do so* is so constantly present that the director cannot do better than refrain from any act which may resemble harshness to the minority.

It is perhaps hardly necessary to warn the director of a parent company which holds a majority of shares in a subsidiary that the majority cannot practice fraud upon the outside shareholders. It is possible,

however, for certain acts to be fraudulent upon a minority in their early stages and for the acts to be confirmed by the majority at a subsequent general meeting. Such acts are equally illegal.

Then there is the case in which the parent company may attempt an imposition which is not fraudulent but which is inequitable. In this case the rule in *Foss* v. *Harbottle* is laid aside and the court will certainly interfere to prevent the wrong.

The next case is that in which the consent of the minority is obtained by trick or without disclosure by the majority of material facts which would cause the minority to withhold its agreement. The minority is able to prevent the parent company from acting upon any resolution obtained in this way (*Baillie* v. *Oriental Telephone & Electric Co.* 1915).

The last case, and perhaps the most important of all, is that of *Brown* v. *British Abrasive Wheel Co.*, 1919, in which it was held that although the shareholders have the right to alter their Articles it is not permissible for a majority to attempt to do so for the purpose of expropriating the minority. The case dealt particularly with an attempt to force a minority to part with its shares, but it is probable that the doctrine will extend to any effort to alter Articles to the detriment of a minority.

The Auditors.

The position of the auditor or auditors in the organization of the company should be grasped thoroughly by all directors. Every company must employ an auditor or auditors to whose inspection the books and accounts of the company must be open at all reasonable times. The auditor is an officer of the company (therefore subject to the provisions of Sec. 215). This ruling was the effect of the decision in *Kingston*

Cotton Mills Case (1896). The remarks of Mr. Justice Lopes in that case sum up concisely certain of the duties devolving upon a company's auditor—

> It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care, and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog but not a bloodhound.

The last sentence is particularly important and must be noted by every director. As a matter of fact it is practically impossible for an auditor to carry out duties approximating to those of a watchdog unless he is in attendance at the company's offices throughout the year. The greater portion of the watchdog's duty must inevitably remain with the directors and they should never allow themselves to be lulled into false security by thinking that sufficient check is placed on the company's funds by visits of the auditor once or twice a year. The installation of an efficient *internal* audit, which will be explained in due course, is a duty resting upon the directors and not upon the company's auditors.

There is no fixed scale of remuneration for auditors. It is usual for the directors and the auditor to agree upon a fee, either fixed or based upon time spent, in spite of the fact that Sec. 112 (s.s. 7) provides that the remuneration of auditors shall be fixed by the company in general meeting. In this case everyday practice carries out satisfactorily what an indefinite and scarcely practical sub-section could not bring about.

Distinction Between the Auditor and the Accountant.

Many companies employ an official known as the accountant, whose duty it is to supervise the

accounting work, which is in such cases separated from the secretary's department. Whether the accountant is a full time employee or a practising accountant, his work consists in the accounting for, and the recording of the company's business as a servant of the directors. He actually writes up, or causes to be written up, all the financial records and he prepares the directors' accounts for presentation to the shareholders. The auditor, on the other hand, is appointed by the shareholders (Sec. 112, s.s. 1). The auditor does not write up the books or prepare the accounts. He only audits the directors' accounts and reports upon them to the shareholders in general meeting. Stress is laid upon the expression "directors' accounts" because it is sometimes thought that it is the duty of the auditor to prepare the accounts and to present them for the directors' approval. This is not so; the directors themselves are responsible for the preparation of the accounts and they do it personally or through their officers, usually the accountant. They then present their accounts to the auditor, who examines them and reports upon them to the proprietors. In practice the auditor frequently does prepare the accounts and on occasions makes entries in the books, but it must always be borne in mind that in such acts he is an accountant and the agent of the directors. The independence of the auditor from the directors must be rigidly observed by the board at all times.

The auditor is free to make any report on directors' actions in any terms his discretion dictates and he cannot be tied by instructions from any board or by any set of Articles. This independence was ably outlined in the case of *Newton* v. *B.S.A., Ltd.*, in which it was held that a company could not adopt Articles

preventing the auditor from reporting on a company's secret reserves if he thought fit to do so. In order that the independence of the auditor may be maintained the Act provides (Sec. 112, s.s. 4) that no person other than the retiring auditor may be re-elected for another year unless notice of the intention to propose some other person has been served at the company's office at least fourteen days before the annual general meeting and that this notice has been notified to the auditor and to the shareholders at least seven days before the meeting.

The Solicitor.

The relation between the solicitor and the company is different from the relation existing between the auditor and the company. The relation is no more than that subsisting between a solicitor and an ordinary client. The solicitor is appointed by the directors and usually charges scale fees for work done. He may be replaced by another solicitor without the sanction of the shareholders and without notice to the members. He is not ordinarily subject to the provisions of Sec. 215, and is not an officer of the company. It may happen, however, that where a solicitor acts in a capacity other than that of a solicitor he may render himself liable to misfeasance proceedings and he may be regarded as a promoter if his actions with regard to a flotation or prospectus exceed those ordinarily required of a solicitor as such in these matters.

Subordinate Officers.

The other officers of a company will vary in number, salary and authority according to the size and business of the company. It is unnecessary to tabulate the usual appointments here, for a director must

appreciate the particular scheme of administration adopted by his company before he can gauge the relative importance of subordinates. In addition to the secretary, accountant, managing director, sales manager and head buyer there may be works managers, technical advisers, general managers, cost accountants and a thousand and one minor officials to whom authority is in greater or less degree delegated. Except as indicated above, however, these officials are not officers of the company within the usual meaning of the Act, and their responsibilities are bounded by the decisions of the board on the matter. A director cannot make any serious mistake if he follows the rough test of responsibility provided by the Act. He will not then be guilty of the error of allowing a technical adviser, for instance, to dictate to, or assume the responsibility of the board. Any pitfalls of this kind may be avoided by insisting that all officials, no matter how high-sounding their descriptions, should approach the board and take their orders from the board through the medium of the secretary.

Harmony in company organization is often subject to the onslaught of a disturbing factor for which the remedy is in the hands of the directors only. Officials with a grievance are often prone to air their complaints by means of communications made direct to individual members of a board. Any tendencies of this sort should be ruthlessly stamped out and the communications treated in the manner accorded to anonymous screeds. Even where a complaint appears to have grounds of justification, the recipient should make it clear that he will not be a party to a departure from the adopted routine of administration. The officials with complaints must not be allowed to cause a rift by passing over the heads of their superior officers,

and it is usually only the directors who can put an end to the practice.

Efficient administration needs harmony, and necessitates a fixed routine in every matter affecting the business of the company and the duties of its officials.

The machinery of administration will be dealt with in the next chapter.

CHAPTER III

THE ADMINISTRATION OF JOINT STOCK COMPANIES

The success or failure of joint stock enterprise probably depends upon the administration to a far greater extent than upon any other factor. Efficient administration can often steer a company successfully through times of deepest trade depression whilst ignorant administration can often ruin another company at a time when trade could offer its brightest hopes of success. Administration depends firstly upon correct organization. It is useless to attempt to administer unless the machinery for the execution of the board's instructions is efficient and able to cope with the demands made upon it. It follows as a natural corollary that a well-organized company cannot work efficiently unless the administration of the board is sound, logical and practical.

The chief essential of administration is that it should be definite and unequivocal. The board cannot vacillate or give ambiguous directions, blaming subordinates for inefficiency when half-hearted plans miscarry. Policy in all matters must be clear cut and the directors must accept full responsibility for their decisions.

Use of Board Meetings.

The decisions of the directors are usually arrived at through deliberations at periodical meetings at each of which it is the duty of every director to attend. The actual decisions upon each particular point are recorded in minutes written up by the secretary from his own notes or those of the chairman. The views

of each director must be obtained by putting the resolution to the meeting and objection should be made if a director is not satisfied that the decision is being correctly recorded.

A great deal depends upon the methods of the chairman. Occasionally chairmen will be found to neglect to put resolutions forward in a manner embodying the various views of members of the board. The secretary is caused considerable trouble if numerous objections are made to the minutes he has framed from the chairman's declarations. Other chairmen are apt to declare their own views on particular matters with such vehemence and authority that their words are taken as the unanimous opinion of the whole board.

Any such tendency to turn the board into a one-man concern must be strongly resisted. No director should allow his judgment to be overruled by any other members unless they have convinced him that he is in the wrong. Directors should not arrive at meetings with only a hazy idea of the general state of affairs, or of the matters which arose at previous meetings. It is a general practice for the secretary to circulate draft copies of the minutes of each meeting prior to entering them in the minute book. The director should examine the draft, prepare any objections he may have and notify the secretary as soon as possible. At the next subsequent meeting he should voice his objection as soon as the chairman asks the directors whether it is their pleasure that he sign the minutes as circulated as a correct record of the previous proceedings.

Should it happen that a director was absent from a meeting he should not gloss over any points in the circulated draft which he cannot fully understand. He should make it his business to have the questions

raised afresh in order that he may obtain the context and grasp the full import of the decision. Too often do directors allow emergency meetings to decide upon important matters and permit the draft of the decisions of meetings, at which they were not present, to receive their tacit consent.

All drafts of minutes should be filed and indexed by the director's private secretary. He will then be in possession of a copy of the minute book together with a record of the names of the directors present at any particular meeting. It is practically impossible for a director to trust to his memory to recall every decision of his board without the aid of his draft. He should refresh his memory from time to time particularly just before meetings at which agreements and financial documents are to be brought forward for sanction. Agreements relating to bank overdraft guarantees, agreements with servants and officers, and agreements for purchase of assets are matters to which a director should give his assent only when he has carefully examined the previous commitments and policy of the company as outlined in the minutes.

A director should always be acquainted with the main objects clause of the company's Memorandum and with the principal Articles of Association. It is indeed advisable for him to carry his copy of the Memorandum with him to each board meeting, for he is bound to consider whether any act of administration in which he participates is *ultra vires* or not. A company is not allowed to carry out acts which are *ultra vires* or not sanctioned by the Memorandum, and should a director acquiesce in the employment of the company's funds outside the scope of the Memorandum he may render himself personally liable for the moneys if they prove to be irrecoverable. It is

true that the court has power to grant relief, but the director should not rely on this doubtful protection.

Administration Through a Managing Director.

Administration through a managing director is sometimes very successful and, strangely enough, sometimes disastrous. Everything depends upon the quality and personality of the managing director himself. Occasionally it is found possible to communicate the decisions of a board to the managing director at board meetings and to leave the administration entirely to him. This practice may be successful in many cases, but it is unwise for the directors to make this autocracy complete or to allow the managing director to constitute himself a committee of one under such circumstances as are permissible by Clause 91 of Table " A."

Table " A " is a model set of Articles applying to companies which do not adopt special Articles. Any clauses of Table " A " which are not specifically excluded by special Articles apply to all companies. Directors should therefore pay special attention to this Clause 91 and to Clause 88 (permitting a small quorum), when examining their company's draft Articles of Association.

There are many ways in which a board may exercise control over the managing director whenever he is entrusted with the administration, principally by the use of financial and production reports of the secretary and works managers, and by the selling and purchasing returns of the sales manager and head buyer. It is essential that these reports should reach the board direct through the secretary. It is unwise to allow the managing director to incorporate them in his own reports, though naturally he will approve them before they are circulated.

Occasionally an attempt is made to form management committees consisting of the sales manager, the head buyer and the managing director or general manager. These three officials must always be in touch with each other, but it will rarely be found to lead to efficient administration to form them into a committee with equal powers. This practice almost invariably leads to dissension and to slack administration. One man only, either the managing director or the secretary, should transmit the policy of the board to the various officers concerned. Committees usually endeavour to dictate their own policy, and at times the individual members usurp the powers of the board. It is not the duty of a managing director or any other officer to dictate his own policy. He must only carry out the administration decided upon by the directors. If he fails in the administration then his responsibility is fixed. It is almost impossible to fix responsibility for failure on a management committee when its members are at variance with one another.

The co-ordination of officers must not be confused with the appointment of management committees. Co-ordination is absolutely essential throughout. If financial administration is delegated to the secretary and general administration to the general or managing director, then responsibility is fairly fixed, for the progress of the company will be communicated to the board from two sources, and the members can form their opinion as to the efficiency of either side of the business. The presence of all senior officials at board meetings is a practice which might be adopted more widely with advantage. It will ensure the disappearance of any vestige of one man control, and will effectively provide the directors with all the information they require. It is necessary, however, even in that case to cause the decisions of the board

to be recorded in the usual manner, and for the secretary to provide memoranda on the decisions to the officials concerned in spite of the fact that they may have taken their own notes at the meeting.

Working Directors.

Occasionally boards are composed entirely of working directors. They meet in board meetings for the purpose of recording their decisions officially. Usually each takes charge of a section of the administration and they then co-ordinate their efforts by means of frequent unofficial conferences. Such conferences differ from the meetings of management committees appointed by a board because the members of the conferences are directors and are responsible to the shareholders direct and not through a board. Dissensions are only likely to arise under the circumstances in which they arise in partnership businesses, and a majority of the directors would then resort to methods similar to those adopted in partnerships in dealing with recalcitrant partners under Sections 24 or 35 of the Partnership Act, 1890. The aggrieved director has of course the remedy of ascertaining the feeling of the proprietors in general meeting. This method of administration is of course the most successful but the one least frequently possible of adoption.

Administration Through a General Manager.

Certain classes of business are of such a nature that although the control should be in the hands of a strong board, the business is actually in the hands of one man. Instances of this class of business will be found in the investment and trust companies. There will be a secretary and perhaps an accountant, but there are of course no sales managers, works managers or buyers. In these cases, though the fact is not

always appreciated, the responsibility of the board is far greater. The power of the manager must necessarily be so wide that the board may find itself in danger of becoming the administered body. In order to maintain as strict a control as possible it is necessary that the board should meet far oftener than in the case of a commercial company. The books of the company should be examined by the board, and every member should understand the principles of finance company's accounting. The board should insist on a monthly audit by an independent firm of auditors, who should report direct to the board after each examination. Every transaction should be recorded in the minutes and the unwise practice of allowing finance transactions up to a stated limit to be carried through without previous or subsequent report to the board should be abolished.

It must be realized that companies of this class are largely at the mercy of one man, and a director taking a seat on a board of such companies is playing with fire unless he makes it his business to control the shareholders' money efficiently and continuously. It is only necessary to remind the reader that most of the company failures which have brought out the danger of inefficient directorship have been non-manufacturing companies. This only emphasizes the danger awaiting the weak, ignorant, careless or amateur director, who is by nature fair game to the captain of finance whose wits, sharpened by years of city experience, permit him to deal successfully with the gentlemen who "direct," "control" and "advise" him in his work.

Directors and Detail.

If the organization of a company has been planned on sound lines, then the administration will flow

smoothly through the channels of delegation. It should be unnecessary for directors to follow their administrative directions through the company. They should decide upon their policy, give their orders, accept or reject quotations, and then await the result of their work. To delve into detail is as great a fault with some directors as the glossing over of principles is with others. Whenever the technical officers have drawn up a scheme for the installation of new plant, or the erection of new shops and this scheme, having received the approval of the sales department, is laid before the board, the members have to weigh the pros and cons, examine the financial aspect of the matter with the aid of a report from the secretary. A decision is then reached and recorded. If it is resolved to adopt the scheme, then all that is necessary is to pass a minute to that effect and allow the officials to proceed. It is no part of the directors' work to usurp the subordinate duties of the works manager, for instance, and to insist on the installation of the plant in any manner other than that which seems best to the man on the spot and his associates. There is nothing to prevent any director from tendering practical advice he may have to offer, of course, but he should not interfere with detail. Similarly it is wrong for directors, collectively or individually, to engage the subordinate staff and foist them upon the secretary or works executives. The secretary is responsible for his department to the board, and interference with the personnel with which he must work is not likely to preserve harmony in administration. It is quite out of place for a director to give directions to a subordinate over the head of superior officers.

In short the directors should direct only, and allow the manager to manage his works, and the secretary

to work his own department. If any officer cannot control his own department successfully, then the only duty devolving on the directors is to remove him.

On the matter of staff it is most important that directors should avoid any suggestion of nepotism. To engage staff from among personal acquaintances, either directly or by exercising influence over the officers, is the most frequent cause of dissatisfaction rife in joint stock companies to-day. It makes the chief officers at one with the lower grades in the feeling of injustice experienced by the latter whenever directors exert an influence contrary to the spirit of their trust.

PART II
The Director and Financial Control

CHAPTER IV

AN OUTLINE OF COMPANY ACCOUNTING AND THE METHOD OF CONTROLLING WORKING CAPITAL

THERE is unfortunately a tendency on the part of some directors to minimize the value of a company's accounting department and to regard its cost as practically wasted expenditure, which must be kept down to its lowest possible limit. Whilst it is true that unless proper control is exercised there is a danger that this department may become overstaffed, it is important to remember that an inadequate or inefficient accounting staff may, as the result of errors, cost the company very considerably more than the extra expense entailed in rendering the staff adequate and efficient. The accounting department should be able to cope with its normal work without working overtime.

In most companies the secretary or accountant will be responsible for the proper functioning of the accounts department, and it is desirable that the board should insist upon the production of a periodical report from the accounts officer setting forth the numbers of persons engaged on accounting work, particulars of their duties, details of the cost of the department and general recommendations for improvements as they suggest themselves to the officer in charge. In order that this report may be properly considered, it is essential that the directors should have a general idea of the accounting system of a

company and for this purpose it is proposed to deal with the matter in broad outline in the following pages. It must be realized, however, that the practical details vary in nearly all businesses and that the application of the principles outlined to a particular company must be left to the individual reader. In every trading business there should be found—

(1) The Cash Record. A continuous record of cash (including cheque) receipts and payments, revealing at any date the amount of cash at the company's bankers or in the hands of the cashier.

(2) The Sales Record. A continuous record of the sales made to customers from day to day, whether for cash or credit, enabling the total sales to be ascertained immediately for any required period.

(3) The Purchases Record. A continuous record of all goods purchased, whether for cash or credit, showing the total purchases at any time for any required period.

(4) The Sales Ledger. A record in the name of each customer of the goods sold to him for credit and the manner in which the goods have been paid for, or the amount still owing from the customer for the goods supplied.

(5) The Purchase Ledger. A record, in the name of each supplier on credit, of the goods purchased from him and showing the manner in which the account has been settled, or the amount still unpaid.

(6) The Nominal, Private or Impersonal Ledger. A record of the cash and credit transactions of the business summarized under headings of expenditure or receipts, enabling a statement to be prepared at any time of the total cost of the concern under each class of expense and the revenue of the company from all sources.

The foregoing six classes of books or records may be said to represent the principles of book-keeping or accounting for a normal business.

Scope of the Accounts Department.

The importance of the efficient working of the accounting department can be appreciated fully only if the objects and scope of the department are briefly indicated—

(1) To Assist in the Control of the Working Capital. This matter is naturally one of extreme importance. The duty of the director in the matter of control of working capital is dealt with fully later, but it should be observed that no control of capital is possible without the aid of an efficient accounts department. Each director should therefore take steps to ensure that his company receives full benefit in this matter from records kept up to date by the officials in the accounts office.

(2) To Prevent Loss and Wastage of the Assets. The chief danger from inefficient accounting is the possibility of loss or wastage of assets. The directors, as custodians of the property of the shareholders, must ensure that the accounting department is properly functioning and preventing such loss or wastage. The manner in which such losses may arise are briefly as follows—

(*a*) Omission to charge customers for goods supplied.

(*b*) Delay in collection of book debts.

(*c*) Duplication of payments for goods purchased or expenses incurred.

(*d*) Failure to detect errors in suppliers' invoices and statements.

(*e*) Inefficient systems of recording stocks.

(*f*) Defalcations of cash or goods.

Directors should make enquiries of the responsible

head of the accounting staff and satisfy themselves periodically that proper measures are being taken to prevent such losses. Further consideration will be given to these sources of loss under the heading " Internal audit in principle."

(3) To Enable Trading and Profit and Loss Accounts to be Prepared Promptly at Regular Intervals. One of the principal causes of bankruptcies and liquidations during the past few years has been ignorance of trading losses until some months after the crucial date at which they commenced.

If a company is to be properly directed it is essential that the directors should know, practically from day to day, whether the company is making a profit or loss. Immediate steps can then be taken to curtail losses or increase profits. Such a grip on the trading results can be maintained only if the accounting staff is working efficiently. Directors of those businesses which lend themselves to the compilation of monthly trading accounts are strongly advised to insist on their adoption. Directors of companies which do not lend themselves to monthly trading accounts should ensure that profit or loss is disclosed as frequently as possible. For the benefit of the reader who may wonder why the presentation of monthly trading accounts is a rather more difficult matter in some companies than in others, it may be explained briefly that the question turns on valuation of stock in hand. The point will be appreciated at a later stage when the compilation of a trading account has been explained, but for the moment the reader is asked to assume that periodical trading accounts are easier to produce in companies possessing a bulk stock in one variety, e.g. coal, than in companies trading in many classes of goods.

Delay in presenting trading results is often a definite

indication of inefficiency in the accounting department and directors should never have occasion to ask "Why were we not informed that these losses were being incurred?"

Control of Working Capital.

It is imperative that the directors should keep a proper control of the working capital of the company at all times. The control must be exercised in such a manner that it covers not only the actual conservation or disbursement of the finances of the company but also the policies directing these acts.

A large proportion of the concerns recently liquidated might have weathered the storm had a proper margin of working capital been maintained during periods of prosperity. The cause of their failure was often due to lack of working capital rather than to trading losses, even though these two are ordinarily corollaries. A reasonable margin of working capital can be maintained only by a strict control of finance not only during times of adversity, but also during times of good fortune.

The annual balance sheet and accounts are practically valueless from the point of view of keeping a grip on finance and it is essential that a statement of working capital be prepared at least every month. It is the duty of every director to see that such a statement is circulated to the board with unfailing regularity.

In a concern consisting of only one department or factory, complete control can be preserved by immediate action based on fluctuations revealed by a statement in the form shown on the next page.

This statement is prepared monthly and is designed to indicate at a glance the points at which economy or care is needed. The first matter calling for

attention each month is the relation which stock bears to the gross working capital. Sufficient margin of the latter over the former must be maintained to meet wages and payments to creditors for the month. The relation between the debts estimated to be collected within the month and the payments which will have to be made to the creditors must be considered with full regard to the terms of credit allowed to the customers and by the suppliers. The terms

STATEMENT OF WORKING CAPITAL

Six months or one year.

ASSETS		Month. £	Month. £	Month. £	Month. £
A. *Stock* at cost or market price, whichever is the lower					
B. *Investments* (other than those earmarked) at realizable value . . .					
C. *Book Debts*—Less Cash Discount & Amounts not anticipated to be collected within one month .	£				
	£				
D. *Cash* at Bank or in Hand . . .					
E. *Other Liquid Assets* .					
LIABILITIES					
F. *Deduct.* (1) Liabilities to Creditors due for payment within one month (2) Capital Commitments falling due during the month .	£				
	£				
Free Working Capital £					

of credit may differ widely, and this must be taken into account by avoiding either over-estimating the book debts receivable or under-estimating the amounts which will be demanded by creditors during the month.

When Working Capital Falls.

As soon as the monthly report shows a tendency for the working capital to fall below a reasonable margin in excess of the amount of stock, steps must be taken to enquire into the cause. Usually this will be found to be due to one or more of the following—(1) Increased output; (2) delay in collection of book debts; (3) increased stock; (4) losses; (5) capital expenditure. Different remedies are needed for each of these factors, and the cause must therefore be isolated and identified with certainty.

Too often a shortage of working capital is wrongly ascribed to trading losses, particularly in cases where monthly profit and loss accounts have not been prepared. When the shortage is due to increased business it will be revealed by the monthly sales returns, and must be remedied at once, either by holding up creditors, if practicable, or by introducing fresh capital. If these courses are not adopted, then the value of a largely increased turnover may be more than offset by the evils accompanying the difficulty of meeting wages and other cash commitments.

An increase in book debts without a corresponding increase in turnover is a common cause of a decrease of working capital. In most businesses this is a seasonal occurrence which should be anticipated and provision made for the fluctuation. If, however, an increase in book debts occurs at a period when not anticipated, immediate enquiry should be directed to the procedure adopted in issuing statements and

following up and collecting book debts. When the stock shows a considerable increase over normal it must be ascertained whether out-of-date stock is being disposed of advantageously and expeditiously, and that the buyer is not stocking heavily without adequate reason. Any tendency on the part of the buyer to speculate in material must be curtailed immediately.

The stock increase may, however, be due to the sales being less than was anticipated, and this will necessitate ascertaining whether the cause is increased competition or general stagnation in trade. In either case effective measures should be taken to avoid a cash shortage in future months, when the effect of a smaller inflow from book debts will make itself felt.

Reduction of working capital due to trading losses should lead to the overhauling of costs, the elimination of all unprofitable work, and to the institution of further economies in production. Under exceptional circumstances it may be necessary to continue trading at a loss until reorganization of factory methods or change of production can be effected, or until a temporary set-back in a particular market is righted. In such cases closer attention must be paid to the other avenues by which resources may be conserved. Every proposed item of expenditure must be more closely scrutinized than normally before the liability is incurred.

Capital expenditure should never be permitted to cause an unexpected drop in working capital. It should be sanctioned only when the margin of realizable assets exceeds all trading requirements. If, however, capital commitments have been entered into without full regard to the amount of cash available, additional capital should be introduced unless

ear-marked investments or fixed assets can be realized.

The remedy must be applied immediately, or credit will be damaged and goodwill lost through delay in completing orders. If additional capital is not available the position may become serious. It must be borne in mind that without a reasonable margin of working capital it is impossible to cope with the increased turnover expected from capital outlay and improvements. If the trading assets are applied to capital expenditure at a time when there is little prospect of obtaining fresh capital, then the benefits may not only prove of little avail but the general financial position may be rendered precarious.

Rationing Departments.

When a concern comprises more than one department the control of working capital is carried out departmentally. The statement is prepared in the ordinary way, but book debts, stocks, and liabilities are shown under departmental heads as well as in total. A rationing scheme becomes necessary, and each departmental head is informed of the maximum capital allotted to him, such maximum being fixed after consideration of the manager's estimate of his requirements in relation to the maximum capital available. Whenever a departmental head or manager is remunerated on his results, interest should be charged to his department, calculated on fixed and floating capital held either at the commencement of each month or from day to day, as may be found convenient. This ensures a check on all tendency to lock up working capital unnecessarily.

Directors perusing this financial barometer will observe at once in which direction enquiry or action is necessary. In some companies the officials are

competent to apply the necessary remedies as and when required, but this does not absolve the directors from taking a directing hand in the matter.

The control of capital is essentially a director's duty. It does not consist in the mere receipt of such a statement as the above; it consists of action based upon that statement. To lay down the statement of working capital without grasping its full import, or to leave a board room without assisting in the formulation of a policy demanded by an unsatisfactory statement is negligence of duty in an aggravated form. A director may possibly neglect his other duties without ill consequence to himself, but he should never neglect the duty of controlling his company's liquid assets in some such manner as that outlined above.

CHAPTER V

PERIODICAL RETURNS

In addition to the capital control statement the director will receive periodical returns, financial and otherwise, from various sections of the business. The object of these returns is, of course, to enable the director to acquaint himself with the vital points in the company's progress from time to time and to render himself *au courant* with any matter of policy which may arise at board meetings.

Unless these returns are prepared with discrimination there is a danger that directors may become flooded with masses of figures which they have neither the time nor the disposition to consider.

It is a good plan therefore for the board of directors to indicate to the secretary the information desired and the periods at which it will be required.

If this procedure is adopted the directors will know exactly what to expect. The matter may be, and often is, left to the secretary, but it is not unknown for a secretary to prepare returns on vital matters demanding instant attention and then to receive a disappointment by finding that the members of the board do not appreciate its importance. For this reason it is always advisable for directors to work out logically a list of the returns they require and to discuss the list with the secretary or with other members of the board.

The presentation of figures in a readily assimilable form has received much consideration during the past few years and the various professional bodies are to be congratulated on their efforts to encourage their members to acquire a practical knowledge of

the science of statistics. Many types of statistical data can better be expressed in graphs or curves than in mere columns of figures. Directors should not allow themselves to become immersed in masses of figures; they should require the secretary to present them in just that form they understand most readily. The secretary will be found quite willing to simplify a statement which he himself understands thoroughly on account of his daily contact with the figures, but which is perhaps obscure to the board.

At this point reference may be made to the unprofitable habit of calling for special returns—involving a great deal of work—the use of which to any director is problematical. Some directors seem blessed with bright ideas and call for involved statistics which can serve no useful purpose whatever. Often the train of thought leading to the demand is a good one, but the resulting request is a wrong one. The time of the secretary and his subordinates should be regarded as valuable and requests for extraordinary information should be made only after consultation with the secretary, who will readily understand the idea at the back of the enquirer's mind and will doubtless produce the required information by shorter methods than those suggesting themselves to the director himself. A secretary may often waste a great deal of time, for instance, preparing statistics from wages sheets and time cards in order to convey information to a director which might readily have been given from the wages book or private ledger, had the secretary known the line of enquiry running through the director's mind.

The returns which are considered essential for most classes of business are set out hereunder. It is recommended that they be prepared for the directors monthly and that they should be available within a

few days of the end of the month. Delay in presenting them reduces their value in proportion to the period of the delay.

(1) Return of Total Sales or Business Done.

The figures of this return will usually be best expressed in sterling, but in some businesses a unit of weight or quantity is found more satisfactory. The return should show the comparison with the preceding month and also with the corresponding month of the previous year.

The object of these comparisons is to indicate whether the variation is due to an abnormal factor or to a normal one such as a seasonal variation.

An unusual drop in the sales figure will warrant close investigation into the cause. In order to identify the largest variations it is very desirable in those businesses possessing more than one sales department, or selling several classes of goods, that the return should be analysed to show the separate sales of the departments or types of product.

The enquiry into the causes of an unusual reduction in sales will proceed upon the following lines—

(*a*) *Is the reduction due to increased competition caused by—*

(1) Reduction in competitors' prices, or

(2) Improvement in quality of competitors' commodities, or

(3) Greater efficiency of competitors' sales organization ?

(*b*) *Is the reduction due to a fall in the general demand caused by—*

(1) Efficient substitutes at lower prices, or

(2) Changes in public tastes or fashion, or

(3) Reduced purchasing power due to trade depression ?

It is not within the scope of this book to deal in detail with the remedies which must be applied when the cause or causes have been ascertained. The necessity for finding out the true causes cannot be urged too strongly and directors should not be satisfied with mere excuses from their officials but should take all possible steps themselves to ascertain the root of the trouble.

If the reduction in sales is likely to continue for some time immediate consideration must be given to the question of keeping stocks within reasonable limits and preventing the locking up of working capital in stocks which can be realized only at a loss. In a merchanting business such steps will be taken to cancel goods on order from suppliers as may be considered expedient, according to the peculiar circumstances of the case.

In a manufacturing concern the limiting of the production may prove necessary. In the latter case it must be borne in mind that any appreciable reduction in output will increase the cost of the articles produced, on account of the fact that the standing charges such as rent, rates, management salaries, etc., will be apportioned over a smaller output. There is the further possibility of losing skilled workmen who may not be available when it is desired to resume increased production.

If the reduction in sales is due to the lower prices of competitors it may be found necessary to increase production substantially in order to lower costs.

These factors must be carefully considered and a definite decision reached. It is dangerous and demoralizing to continue without a definite policy in the face of such conditions.

Unaccountable Increase in Sales. An unaccountable increase in the sales figures does not

necessarily indicate an improved financial position. It may be that selling prices are too low and that either no profit or an insufficient margin of profit is being made. There is the further possibility of stocks becoming exhausted to the detriment of standing orders or the goodwill of regular customers. Again, the financial position of the company may not be strong enough to stand the strain of carrying a considerable increase in book debts requiring, say, 3 to 4 months' credit while the payments for wages and supplies have to be made promptly or within one month.

Unaccountable increases in sales sometimes point to over-trading and cannot always be taken as indications of prosperity.

(2) Return of Production or Output.

Production or output of a business has a direct bearing on the cost price of each unit. Where selling prices are fixed, any substantial variation in the cost prices affects the profit directly. It is therefore important that periodical returns of production should be laid before the board. Some businesses lend themselves to weekly returns, others to monthly, and others to quarterly returns. Each business must select the most suitable period, but just as in the case of trading accounts, so with production returns—they must be prepared as frequently as possible, regularly, and promptly.

The production return is prepared to show either the quantities produced or the sterling value at cost or selling prices of each unit. A specimen return is shown on the next page.

In certain businesses carrying out large contracts over lengthy periods it is possible that no production report will be available. In such cases the amount expended during the month on wages and materials

PRODUCTION RETURN

Month ending....................19..   Branch or Department.

(a)	QUANTITIES (in appropriate Units), and/or VALUES.											
	Last Year.						This Year.					
	Month.			Year to date.			Month.			Year to date.		
	Class "A."	Class "B."	Class "C."	Class "A."	Class "B."	Class "C."	Class "A."	Class "B."	Class "C."	Class "A."	Class "B."	Class "C."
Opening Stock . . .												
Production for month . .												
Total . .												
Invoiced during month .												
Outside Customers .												
Associated Companies .												
Total .												
Closing Stock . . .												

will be a satisfactory guide to the volume of business done and a statement embodying this information should be called for.

(3) Return of Outstanding Orders.

In most classes of business it is not practicable to execute all orders received immediately on receipt and businesses which are accustomed to carry a large number of unexecuted orders are therefore obliged to gauge their progress from the amount of orders on hand at any time.

Directors can obtain most valuable information from this return which is, in many respects, of greater value than the ordinary sales return. It often anticipates drastic variations in the sales returns by several months and enables changes of policy to be effected before any serious loss has been sustained through falling off in sales. Again, it enables works and financial arrangements to be made for a largely increased output without disorganizing the general arrangements of the business.

The period and form of this return will vary with the peculiarities of the business, but generally speaking it is desirable that it should be prepared at least once a month and that it should show quantities of goods on order classified under types of commodities. Comparison should be made with the quantity of orders unexecuted at a corresponding date in the preceding year and also with the preceding two or three months of the same year.

(4) Return of Working Capital.

This return has been fully dealt with in the second section of this chapter, but reference must be made to it in connection with book debts and stocks.

It is a strange but established fact that these two assets always tend to increase unnecessarily unless there exist satisfactory arrangements for keeping them constantly under review.

No company can afford to have money locked up in book debts and stocks unnecessarily. Neither of these assets produces revenue, both cost money to preserve, and one of them requires warehousing—an expensive item even when the warehousing is provided in the company's own premises.

Stocks rarely improve in value with warehousing, and book debts certainly do not appreciate if allowed to remain outstanding. It may be stated with certainty that with the exception of stocks such as maturing spirits, both stock and book debts depreciate more rapidly than any other asset—fixed or circulating—owned by the company.

Sufficient has been said to indicate the importance of keeping these two assets constantly under review. If the relation which each bears to the amount of the preceding month's sales shows a gradual consistent increase each month then this constitutes a danger signal which cannot be ignored. It is imperative that investigation should be made immediately into the production, sales and accounting organization and for the company's policy in these matters to be brought under review. The secretary and the sales manager are the two officers to whom the directors must turn for information in this matter.

(5) Monthly Profit and Loss Accounts.

Reference was made to this form of periodical return in Chapter IV in connection with the object of a company's accounting system. The remarks were restricted, however, to pointing out the importance of periodical trading and profit and loss accounts

generally, and no attempt was made to explain them in detail or to indicate the method by which they may be understood. An explanation of the import of these accounts will now be given.

The terms "trading account," "manufacturing account," "distribution account" are sometimes used to indicate certain sections of the main profit and loss account but for the purposes of this book the general term "profit and loss account" will be adopted. It may be advantageous however for the reader to be able to distinguish between the various sections, and for this purpose the following brief explanations are given—

MANUFACTURING ACCOUNT. This section of the profit and loss account contains all the items of expenditure incurred by the works in the actual production of the manufactured article. The chief factory or works items of expenditure are workmen's and foremen's wages, materials used, gas, electricity and water consumed, rent, rates, insurance, etc., of the factory, remuneration of the works manager, his clerical and technical staff, and the general expenses of the works, such as carriage and cartage, labourers' wages and cleaning charges.

In the case of a factory producing but one type of article it will be seen that the division of the total charges in the manufacturing account by the number of articles produced, will give the cost of manufacture per unit. This figure of cost is termed the "works cost" or "prime cost" or "production cost."

The advantage of knowing the works cost of a particular article as distinct from total cost will be dealt with in Part III in connection with production control, but in order that the director may understand the composition of the manufacturing account

when it is laid before him the following example is given—

MANUFACTURING ACCOUNT

Dr. For the Month Ended 31st January *Cr.*

Production for Month: 110,000 Units.

To Stocks at 1st Jan.—		£		£
Raw Material . . .		13,000	By Trade Price of 110,000 Units manufactured transferred to Trading Account . .	117,962
Work in Progress . .		16,112		
,, Purchases of Raw Material .		45,040		
		74,152		
Deduct Stock at 31st Jan.—				
Raw Material	£10,050			
Work in Progress	20,700			
		30,750		
		43,402		
,, Carriage on Raw Materials .		850		
,, Manufacturing Wages . .		45,500		
Prime Cost .		89,752		
,, Factory Oncost—				
Rent and Rates on Factory		1,201		
Gas, Light and Water .		1,693		
Wages and Factory Salaries		1,943		
Repairs and Renewals .		1,030		
Depreciation . . .		1,100		
Interest on Capital . .		2,500		
		99,219		
Deduct: Proportion of On-cost on Increased Work in Progress . . .		932		
Total Factory Cost of Production—110,000 *Units* .		98,287		
,, Gross Profit on Works Production		19,675		
		£117,962		£117,962

It will be observed from the above illustration that—

(*a*) The manufacturing account is credited with the wholesale price of the articles manufactured during the month and is debited with the manufacturing cost.

(*b*) The production, 110,000 units, divided into the total works cost gives works cost per unit, namely £·8935.

(*c*) The difference between the total expenses and the value of the production when derived in a similar manner to that shown above gives works profit or loss. The importance of this matter will be

appreciated by directors who may not previously have seen a loss tracked to the factory. It is often impossible to trace the point at which losses are incurred from an account in which all sections are combined under the general heading of profit and loss account.

The profit on the above manufacturing account, viz., £19,675 is carried forward to a distribution account, whilst the goods at wholesale price (£117,962) are transferred to the trading account.

TRADING ACCOUNT. This account sometimes takes the place of the manufacturing account in those businesses engaged in merchanting only, i.e. buying and selling completely manufactured articles, but in the present instance the account is debited with the wholesale price of goods manufactured, and the expenses of insurance and warehousing. The account is credited with the total sales price of the goods sold during the period and with the value of the stock in hand at the end of the period after deducting the value of the stock at the commencement of the period. The difference between the total debits and credits represents the profit or loss on trading and is transferred to the distribution account.

The following is an example, in a form similar to that in which it should be produced to the board, of a trading account of a manufacturing concern—

TRADING ACCOUNT

Dr. FOR THE MONTH ENDED 31ST JANUARY *Cr.*

	Units.	£		Units.	£
To Wholesale Price of Goods Manufactured: Transferred from Manufacturing Account . .	110,000	117,962	By Sales . . .	92,500	143,904
,, Warehousing and Insurance . .		1,168	,, Stock— At 1st Jan. 35,600; ,, 31st Jan. 18,100	17,500	15,636
,, Trading Profit carried to Distribution Account .		40,410			
	110,000	£159,540		110,000	£159,540

It will be noticed that the compilation of the above account requires the inclusion of two stock figures, the opening and the closing stock. Unless the increase or decrease of stock is taken into account in this way the account is useless. Stock-taking is usually a lengthy and arduous task except in the case of single-unit companies. In the latter case valuation of the stock on hand may be carried out in a very short space of time from the office records. In the case of companies dealing in all classes of commodities, the valuation of the stock must necessarily be a lengthy procedure even when the office records are relied upon and a physical check is dispensed with. It will be realized then that whereas a weekly account may be produced by one company, another will find it difficult to produce one at less than three months' intervals. It is a common practice now to estimate the stock for the monthly account by deducting the known average gross profit percentage from the sales. This method is satisfactory when the market selling price is stable, but not otherwise.

DISTRIBUTION ACCOUNT. This section of the profit and loss account contains all the expenses incurred in selling and distributing the goods to the customers and comprises such items as travellers' salaries and expenses, agents' commission, advertising, and carriage outwards.

The difference between the total expenses of distribution and the trading profit is carried forward to the general revenue account.

GENERAL REVENUE ACCOUNT. Into this account will be brought the balance of the profit or loss from each of the works or departmental distribution accounts. To this account such items as head office salaries and administration expenses are charged, together with directors' fees, bank and other interest

payments, income tax on profits and any expense of a revenue nature which has not been charged in either the manufacturing, trading or distribution account.

This account is credited with any interest or dividends received from investments in subsidiary or outside companies.

The balance of the general revenue account represents either the balance of profit or the net loss for the period. Whether the profit is a profit available for distribution to the shareholders or not depends upon other factors which will be discussed later.

DIFFERENCE BETWEEN MONTHLY AND ANNUAL ACCOUNTS. The monthly profit and loss accounts prepared for the information of the board need not necessarily be compiled with that meticulous care necessary in the case of the annual accounts. The object of the monthly account is to give the directors an opportunity of ascertaining weak points in the company's affairs before serious damage is done, and to enable them to take steps to prevent their continuance.

In certain classes of businesses only approximate monthly accounts can be prepared. Provided the margin of possible error is not excessive compared with the trading results shown in the final accounts, then the monthly accounts are of great use. The ideal is, of course, to obtain monthly accounts with the greatest possible degree of accuracy consistent with the expense and time of the staff available. The value of these accounts lies chiefly in their comparison with the figures of the preceding months and the form in which they are presented should enable comparisons to be made with as much facility as possible. Any substantial increase in an item of expense or reduction in an item of receipt should be the subject of immediate enquiry.

CHAPTER VI

THE BALANCE SHEET

Equally important with the periodical returns and revenue accounts of a company is, of course, the balance sheet. It is a remarkable fact that many directors regard balance sheets with dread and find themselves unable to grasp the principles upon which they are compiled. This difficulty is more apparent than real and disappears if the distinction between a profit and loss account and a balance sheet can be thoroughly grasped. That the difference is not appreciated is known from the procedure which follows the presentation of many draft balance sheets to boards to-day. Many directors will persist in looking for wages or other revenue items which happen to be under discussion in the balance sheet, or endeavour to join in a parley on intangible assets with the profit and loss account before them, utterly failing to grasp the points at issue. Such farcical procedure can be obviated only if the director has a clear idea of what a balance sheet really is, and is able to follow the principles involved when resolutions are passed affecting the company's accounts. A profit and loss account is a summary of revenue payments such as wages, material, gas and salaries, etc., expended or consumed in the process of trading, balanced against the revenue receipts such as sales, interest received, dividends received and similar earnings of the company in its business over a period. Stress is laid upon the words "over a period." A balance sheet, on the other hand, consists of a summary of the assets balanced against the liabilities at a given date. By comparing a balance sheet with a preceding one it is thus possible to

observe the changes which have occurred in the assets and liabilities as a result of trading.

Whereas a profit and loss account tells whether a profit or loss has been made, the balance sheet shows the form in which that profit exists or the effect that loss has had on the general position of the company. It follows that the general policy of the board over a longer period than that covered by the working capital statement will be governed to a great extent by the general position of the whole company as it exists from time to time and as it is revealed by the balance sheet. The statement of working capital is thus ancillary to the balance sheet and it is the latter statement which the directors must bear in mind when considering proposals designed to alter materially the composition of the assets existing at any time. It must be remembered that it is only the members of the board who will realize that extensive capital outlay on new buildings will transform a liquid asset, cash, into a fixed asset, or that the purchase of a large amount of new plant by means of a loan will increase an asset and introduce a new liability in the balance sheet. The works executives cannot be expected to be in possession of this information. They will quite naturally put forward new schemes from their own point of view without concern for the financial aspect. The directors, and the directors alone, are responsible for considering every proposition of magnitude with a bird's-eye view of the company's position in mind—and that bird's-eye view can be acquired only through understanding exactly the meaning of the balance sheets laid before them.

Works executives often press for the installation of additional plant to cope with an unexpected rush of orders. The directors must consider whether

sufficient evidence exists that the increased trade will continue and that sufficient capital is available to pay for the additional plant and to meet the extra revenue charges involved by an increased output. Again, the sales department may press for the establishment of retail shops in additional districts ; the board must consider whether these districts are suitable and that a sufficient demand exists for the particular commodities at the disposal of the company, paying due regard to their special qualities, and deciding whether the finances of the company permit the expenditure without prejudicing the company's existing business.

The directors will doubtless be able to judge readily the value of such proposals from a commercial or non-financial standpoint. The financial aspect is, however, a far more difficult and dangerous one, for a false step may not only ruin the possibility of extending the business, but may also prove disastrous to the entire company. A decision on such matters which necessarily affect the company's policy should be taken only after a close study of the position revealed by the balance sheet and a mental consideration of the changes likely to occur in the account if the proposals are adopted.

The balance sheet reveals the financial position of the company as at the date appearing upon it ; that is to say, it shows whether the original capital subscribed by the shareholders is intact, and in what form of asset that capital exists. It shows the amounts owing by the company and the assets most readily available to meet those liabilities. A detailed balance sheet should be placed before the directors at frequent intervals, at least every quarter, in order to confirm their views of the company's financial position gathered from the periodical returns. An

audited balance sheet must be issued to the shareholders at least once a year and in the case of public companies in England a copy must be filed at Somerset House (Sect. 26). The balance sheets of public companies are naturally subjected to much criticism at the hands of shareholders and financial critics, and if the company's standard and credit is not to be damaged it is of the utmost importance that the published balance sheet and filed statement should be set out in a satisfactory manner. This matter will be dealt with at length in a later section.

Balance Sheets of Other Companies.

From time to time the directors will doubtless consider the desirability of acquiring or financing other businesses with a view to ensuring supplies or securing the goodwill of valuable customers. The terms of the purchase or financial arrangements will depend to a large extent on the value of the net assets at the date of the purchase as disclosed by the latest balance sheet. The decision for or against the scheme can be made only after a consideration of the balance sheet. It is of the utmost importance therefore that directors should be able to understand not only their own balance sheet but any balance sheet laid before them, for they cannot otherwise be expected to give a reasoned decision on matters which depend to a large extent on such statements. For this purpose it is not necessary to be learned in the academic side of accounting practice but each director must at least know where to find an item at once and be able to appreciate immediately the relation and distinction between assets and liabilities.

An Imaginary Draft.

In order to understand the balance sheet it will be

found a useful practice to carry in mind an imaginary draft form without figures, and to apply this mental picture to each actual balance sheet to be considered. Most balance sheets are prepared in this country in a similar form, but there are exceptions, which may be disposed of at once—

(1) Statutory companies' balance sheets are prepared on the "Double Account" system. This class of company is incorporated under special Act of Parliament and is governed by its own statute. The form of its balance sheet is subject to the statutes, and its accounts must be presented in the manner required by law. Examples of Double Account Balance Sheets are those issued by railway companies.

(2) Companies in which public confidence is an important asset, e.g. banks. Such companies place their assets in the balance sheet in the order of realizability, "Cash" being placed first. As will be seen below, this is a departure from commercial practice.

Apart from those exceptional instances, the balance sheets of English companies are made up as follows—

BALANCE SHEET. AT (*Date*)

Liabilities.	*Assets.*
Capital (amount subscribed to the business by the shareholders or proprietors) and representing the Company's liability to them.	(In order of non-realizability), e.g. Land and Buildings.
Debentures, loans, etc.	Plant and Machinery.
Amounts due to Creditors for goods supplied or services rendered to the Company.	Fixtures and Fittings.
Reserves for amounts which have accrued due and will become payable at a future date.	Stock on Hand.
	Amounts due to the Company for goods supplied or services rendered by the Company, i.e. book debts.
	Cash at Bank and in hand.
	And lastly, intangible assets such as— Goodwill. Preliminary and Formation Expenses.

Finally the balance of Profit and Loss Account.

If the company's trading has resulted in a loss the balance of the profit and loss account will be a debit balance and will appear on the assets side of the balance sheet. The object of this is obviously not because a loss is considered to be an asset. From a theoretical standpoint the loss should be shown on the liability side of the balance sheet and deducted from the amount of the shareholders' capital, the capital having been reduced by the amount of the loss. In practice, however, it is found more convenient to show a debit balance on the opposite side as a contra to the capital account. If the company has had the misfortune to make continual losses, then the accumulations are carried forward from year to year until subsequent profits have entirely extinguished them. It is for this reason that it is considered more convenient to regard a debit balance as a temporary item and to show the capital account as the amount subscribed by the shareholders, the profit and loss balance appearing as a separate item in the account. From a consideration of the foregoing remarks it will be obvious that if the result of the company's transactions has been a profit the balance of the profit and loss account will appear on the liability side of the balance sheet, this being a liability of the company to its shareholders, additional to the amount of capital subscribed by them.

In the draft form of balance sheet shown above, such complications as reserves and reserve funds have been omitted for the present in order that the main and essential features of a general balance sheet may not be obscured. This elementary form should be clearly in the mind of every director when considering accounts. He must be careful to remember that revenue items do not appear in the balance sheet but in the profit and loss account,

and that the balance sheet consists of a statement of the company's liabilities and assets at a definite date. At that date the business owed the amounts shown on the liabilities side and possessed the items shown on the assets side.

The Original Balance Sheet.

When the company first commenced business the liabilities equalled the assets as shown in the following example—

BALANCE SHEET. At Commencement of Business.

Liabilities.	£	*Assets.*	£
Capital (due to shareholders or proprietors) . . .	500,000	Cash (or assets purchased with cash)	500,000
	£500,000		£500,000

At the end of the first year, assuming a profit of £25,000 to have been made, the balance sheet would appear somewhat as follows—

BALANCE SHEET. At End of First Year.

Liabilities.	£	*Assets.*	£
Capital (as before) . . .	500,000	Land, buildings, plant, stock, book debts, cash, etc. .	548,000
Sundry Creditors . . .	16,000		
Reserve for taxation . .	7,000		
Profit and Loss A/c:			
Net Profit for year as per Profit and Loss A/c .	25,000		
	£548,000		£548,000

If the first year's working had resulted in a loss of £25,000 then the balance sheet would have appeared somewhat as follows—

BALANCE SHEET. At End of First Year.

Liabilities.	£	*Assets.*	£
Capital (as before) . . .	500,000	Land, buildings, plant, stock, book debts, cash, etc. .	491,00
Sundry Creditors . . .	16,000	Profit and Loss A/c:	
		Loss for year as per Profit and Loss A/c . .	25,000
	£516,000		£516,000

These simple examples show—

(1) How the cash originally invested by the shareholders is represented at the date of the balance sheet.

(2) The additional capital which has been gained by trading (i.e. when the profit and loss balance appears on the liability side).

(3) The amount of the original capital which has been lost (i.e. when the balance of the profit and loss account appears on the assets side).

Classes of Assets.

The next point to be observed in considering a balance sheet is the classification of the assets. Some of the assets appearing on the face of a balance sheet are not necessarily realizable at the figures shown, these figures representing their value to a going concern.

There is little doubt that on a forced sale few companies would realize the whole of their assets at their book values. For the purpose of considering their realizability assets are, therefore, divided into three classes as follows—

(*a*) Fixed Assets; i.e. assets of a permanent nature, such as buildings, plant and machinery, etc., which are retained in the business for the purpose of earning revenue.

(*b*) Floating Assets; i.e. assets which are constantly changing their form in the process of earning revenue, e.g. cash which becomes raw materials, then stock-in-trade, then book debts or bills receivable, then cash again, and so on.

(*c*) Intangible Assets; i.e. assets which have no intrinsic value in themselves, but which are of value to the company as a going concern, e.g. goodwill, trade marks, preliminary expenses, etc.

In order to consider the approximate value of a company as disclosed by its balance sheet it is essential to recast the assets (mentally at first) under the three headings just indicated.

For example, assuming that the following balance sheet is presented—

BALANCE SHEET. As presented.

Liabilities.	£	*Assets.*	£
Capital	500,000	Buildings	200,000
Creditors	15,000	Plant and Machinery	150,000
Profit and Loss Account	45,000	Fixtures and Fittings	15,000
		Stock-in-Trade	50,000
		Sundry Debtors	30,000
		Bills Receivable	10,000
		Cash at Bank	25,000
		Patent Rights	10,000
		Preliminary Expenses	5,000
		Goodwill	65,000
	£560,000		£560,000

The director will recast it for the purpose of his own deliberations in a form somewhat similar to the following—

BALANCE SHEET. As Recast.

Liabilities.	£	*Assets.*	£	£
Capital	500,000	*Fixed Assets*—		
Creditors	15,000	Buildings	200,000	
Profit and Loss Account	45,000	Plant and Machinery	150,000	
		Fixtures	15,000	
				365,000
		Floating Assets—		
		Stock-in-Trade	50,000	
		Sundry Debtors	30,000	
		Bills Receivable	10,000	
		Cash at Bank	25,000	
				115,000
		Intangible Assets—		
		Patent Rights	10,000	
		Preliminary Expenses	5,000	
		Goodwill	65,000	
				80,000
	£560,000			£560,000

In the case of most companies (other than post-war boom promotions) the value at which the *fixed assets* appear in the balance sheet should give a good general idea of their present value. If the accounts

have been properly prepared and audited, the value of the *floating assets* as shown in the balance sheet should represent their true value at that date.

The valuation of *intangible assets* presents many difficulties and depends very largely on the peculiar circumstances of each case, and the amount which a prospective buyer is prepared to give and a seller to accept.

Well-managed and flourishing companies prefer to write off their intangible assets out of profits as soon as circumstances permit.

Turning to the liabilities side of the balance sheet, and using the following example, we may give an explanation of the usual items encountered—

BALANCE SHEET. AT 31ST DECEMBER, 1923.

Liabilities.	£	£
To *Share Capital, Authorized and Issued*—		
20,000 6% Cum. Pref. Shares of £10 each fully paid		200,000
320,000 Ordinary Shares of £1 each fully paid		320,000
„ 6% Debenture Stock		200,000
„ Sundry Trade Creditors		24,331
„ Bills Payable		5,447
„ Reserve Fund		60,702
„ Leasehold Redemption Fund		94,311
„ Unclaimed Dividends		375
„ *Profit and Loss Account*—		
Balance at 1st Jan., 1923	6,414	
Profit for year, as per Profit and Loss Account	57,420	
		63,834
		£969,000

Assets.	£	£
By *Leasehold Premises* (*at cost*)		150,000
„ *Plant and Mach'ry*—		
As at 1st Jan., 1923	95,900	
Less: Depreciation (at 10% per ann.)	9,590	
		86,310
„ *Fixtures, Fittings and Furniture*—		
As at 1st Jan., 1923	15,800	
Less: Depreciation at 5% p.a.	790	
		15,010
„ *Investments*—		
Consols (at cost)	60,702	
In subsidiaries (at cost, less depreciation)	75,000	
		135,702
„ Leasehold Redemption Policy		94,311
„ *Stock-in-Trade* (at cost or market-buying price, whichever is the lower)		193,760
„ *Sundry Debtors* (less reserve for bad and doubtful debts)		12,483
„ Bills Receivable		48,905
„ Cash at Bank and in hand		129,340
„ Preliminary Expenses		13,595
„ Goodwill (at cost)		89,584
		£969,000

Share Capital.

This liability represents the capital subscribed by the shareholders.

It is usual to include in the balance sheet, by way of a note only, a statement of the authorized capital as fixed in the Memorandum of Association. This is advisable in all cases, but particularly when the whole of the capital has not been issued.

Debenture Stock.

This represents cash advanced by one or more persons on the security of some or all of the assets which are thereby charged to the debenture holders. If default is made by the company in paying interest on the debenture or in complying with any other of the terms of the trust deed, the debenture holders usually have the right to dispose of the assets charged to them in the manner set forth in the deed.

Under the provisions of the Companies Consolidation Act, 1908, any mortgages or debentures created by a company must be registered with the Registrar of Joint Stock Companies (Sec. 91).

Sundry Trade Creditors.

This item represents the amounts due by the company for goods supplied or services rendered to the company. It is sometimes open to such abuses as the concealment of bank overdrafts and loans to the company of a nature which might not appeal to the shareholder. This matter will be dealt with in the chapter devoted to the preparation of accounts by boards of directors.

Bills Payable.

These are comparable with trade creditors, except that the company has undertaken to pay these amounts

at a fixed future date. Failure to pay the amounts when due seriously damages the company's credit unless previous arrangements have been made with the holders of the bills to retire them and extend the tenor. A dishonoured bill gives the creditor an alternative right of action of suing on the dishonoured bill instead of for the debt. The former alternative obviates the necessity of proving either the amount of the debt or that the goods were supplied, or that the services were rendered.

Reserve Fund.

This represents a sum set aside out of profits for a general strengthening of the company's financial position. This matter will be fully dealt with in the last section of this chapter. It will be observed that an investment in Consols appears on the assets side of the balance sheet corresponding to the amount of the reserve.

Leasehold Redemption Fund.

This represents sums set aside out of profits towards the cost of renewing the lease at the expiration of its term. It will be noted from the assets side of the balance sheet that the sums set aside each year have been paid to an insurance company, in connection with a leasehold redemption policy taken out by the company, to provide the necessary capital when required for renewing the lease without disturbing the general finances of the company.

Unclaimed Dividends.

This item relates to dividends declared in previous years in respect of which some shareholders have either omitted to cash their dividend warrants or failed to register a change of address and omitted

to claim the dividend. The company's liability to pay these dividends continues, subject to the usual rights under the Statute of Limitations.

Sufficient has now been said to enable the director to carry out an analysis of a balance sheet. Detailed explanation of the compilation will be given in a subsequent chapter.

CHAPTER VII

THE FINANCE OF SUBSIDIARIES

It is now possible to deal with an important matter of finance with which the director must be familiar, namely, the financing of subsidiaries. The extension of joint stock company enterprise from that of single companies to combines of parent and subsidiary companies has produced many new problems in company finance. The question has to be considered by the parent company from many aspects, particularly to ensure that capital is not unnecessarily locked up in certain of the subsidiaries at the expense of others which might more profitably make use of it.

The main methods of financing subsidiary companies are as follows—

(*a*) By taking up issued share capital.
(*b*) On secured debentures or loans.
(*c*) On open loans.
(*d*) By supply of goods on credit.

The matters affecting these methods and requiring careful weighing one against the other are set forth hereunder—

Issued Share Capital.

As a general rule it is advisable that the issued share capital of a subsidiary company should be kept as low as is considered sufficient to induce suppliers to give the company the necessary amount of credit, firstly, in order that the stamp duties will not be

prohibitive, and secondly, because a small issued capital does not act to the detriment of the parent company from a dividend or taxation standpoint. Rather does it assist the parent company in these respects in a manner to be explained later. A small issued capital has an added advantage that in the event of the liquidation of a subsidiary the parent company's cash advances rank for repayment with the other creditors' claims and are not deferred as is the parent company's claim for return of share capital taken up.

Secured Debentures or Loans.

The advantage of this method of financing a subsidiary is that the parent company becomes a secured creditor for sums advanced (other than share capital) and ranks before the ordinary creditors up to the value of the security.

The objections to this method are that charges of such a nature must be registered with the Registrar of Joint Stock Companies. The information becomes public knowledge and may affect the subsidiary's credit. An *ad valorem* stamp duty is also payable on the amount secured. The parent company's position from dividend and taxation standpoints is not assisted by this method of financing. It will be observed from these remarks that the only advantage of this method is that the parent company apparently obtains priority in repayment of its advances as against the ordinary trade creditors. The word "apparently" is used because in practice it is generally found that if a parent company permits one of its subsidiaries to go into liquidation without paying the trade creditors in full, the credit of the parent company is so seriously affected that it withstands the shock to its goodwill only with great difficulty.

Open Loans.

The advantages of this method of financing as compared with the share capital or secured loan methods may be stated as follows—

(1) No stamp duties are payable.

(2) The credit of the subsidiary is not damaged, because the creditors' rights are not affected, except to the extent that the parent company ranks *with* the trade creditors for repayment of its advances instead of *after* as in the case of share capital.

(3) The position of the parent company as shareholder from a dividend standpoint is assisted as will be seen from the remarks which follow. If the subsidiary sustains such heavy losses in one or more periods that several years would be required in which to wipe off the debit balance, the parent company can, if it so desires, remit part or all of any open loans outstanding. The remission of these loans can then be applied by the subsidiary towards the extinction of the debit balance on profit and loss account. The extinction of the debit balance will permit the subsidiary to declare dividends to the parent company as soon as profits are made. By this means the accounts of the parent company will present an accurate view of each year's trading of the whole group, that is to say, the parent company will charge to revenue, in each year in which the subsidiary makes a loss, a sum equal to the amount of the loss and will credit this sum to the subsidiary's loan account. The subsidiary will credit profit and loss account and extinguish the amount of the year's loss, debiting the parent company's advance account. In the years in which the subsidiary makes profits, a dividend will be declared to the parent company to the extent of the year's profit.

Apart from profits or remission of debts and advances as outlined above, the only other alternative method of extinguishing a debit balance on profit and loss account is by a reduction of the issued share capital. The objections to this method are that application to Court is necessary, considerable publicity of the reduction is inevitable with consequent damage to credit, and legal and other expenses must necessarily be incurred. It will readily be appreciated, therefore, that the extinction of profit and loss debit balances by means of remission of advances has considerable advantages.

(4) The parent company's taxation is assisted. The Inland Revenue has not so far admitted that a subsidiary company is for income tax purposes owned by one and the same persons as those owning the parent company. For all practical purposes the shareholders of the parent company are the owners of the subsidiary company, but this practical view has not been generally accepted by the Inland Revenue, except in a few special cases. When a parent company makes profits and a subsidiary makes losses, the parent company pays income tax on its own profits but obtains no taxation relief in respect of its subsidiary's losses. If the subsidiary subsequently makes profits, some partial relief may be obtained through the incidence of the average system of taxation which is explained in Chapter XII. When a parent company makes trading losses but the subsidiary makes profits a similar position arises, except that if the subsidiary company declares dividends to the parent company the latter can claim a refund of the tax deducted by the subsidiary on payment of the dividend, up to tax on the amount of the trading loss. It is important, therefore, from a taxation standpoint that subsidiaries should declare the largest

dividends possible whenever a substantial loss is sustained by the parent company.

It has already been indicated that the method of financing subsidiaries by means of open loans which can be waived when circumstances necessitate, enables subsidiaries to declare dividends at the earliest possible moment. In this respect, therefore, the open loan method of financing may considerably assist the parent company from a taxation standpoint. It must be mentioned, however, that when advances are remitted by a parent company the loss thus sustained by the latter is not allowed as a bad debt in the Income Tax computation of the parent company.

Supply of Goods on Credit.

When a parent company supplies a subsidiary with goods the subsidiary can be financed by allowing it to pay for the goods after as long a period of credit as is found to be necessary. The advantages of this method are—

(1) No stamp duties are payable.

(2) The credit of the subsidiary is not damaged.

(3) The position of the parent company as shareholder from a dividend standpoint is assisted.

(4) The parent company's taxation is assisted.

The details of the advantages are similar in this case to those under the open loan method, with this addition, viz., that in the event of the liquidation of the subsidiary any amount not recovered by the parent company will be allowed as a bad debt in the parent company's Income Tax computation. There is also every probability that in the event of it being found necessary to remit debts owing by the subsidiary without actual liquidation of the latter, the amounts remitted will be allowed as bad or doubtful debts in the Income Tax computation of the parent company.

In concluding the consideration of the question of financing subsidiaries, it should be observed that in order that the trading results of subsidiaries may appear in proper perspective it is essential that interest should be charged to subsidiaries at current rates on the amounts advanced by the parent companies. Some parent companies charge interest at current rates on the issued share capital of the subsidiary, and credit any dividends to the interest account. Such a procedure gives the parent company a correct view of the result of its investments in subsidiary companies and is to be commended. It must be observed, however, that credit should not be taken in a parent company's profit and loss account for interest charged to a subsidiary unless the subsidiary company's profit and loss account shows a profit after charging the interest.

CHAPTER VIII

THE DIRECTOR AND INTERNAL AUDIT

WHEREAS the investigation into a company's accounts by independent auditors is a statutory obligation, the institution of an internal system of audit is quite voluntary. The installation of such a check upon the company's funds is one of the duties of the directors, and the matter therefore falls to be dealt with at this point. In the first place it must be realized that annual visits by independent auditors, though leading to the detection of fraud which has been perpetrated since their last audit, will not act as a deterrent except when the time of the visit approaches. Defalcations may possibly commence immediately after the conclusion of the audit and continue for a space of twelve months before the auditors' next investigation. The duty of conserving the company's funds rests upon the directors, and it is therefore imperative that they should satisfy themselves personally that a perpetual check is maintained within the company's own organization.

An internal audit need not necessarily be elaborate. It may vary from a separate department of several members down to a system entailing no additional staff but consisting merely of sets of rules for the staff to follow in all cash dealings, designed to render fraud impossible. If the company can support a large organization then the addition of a separate internal audit department of, say, two or three members will not usually strain the company's finances unduly. This department is placed under the charge of a competent officer, preferably with auditing experience.

He is, and must be, absolutely independent of every officer of the company except the members of the board. Occasionally he is instructed to report to the managing director, but this practice is not desirable unless there are very special circumstances warranting the procedure. It is advisable that the internal auditor's reports should be passed to the directors by that officer himself. It must not be thought that this procedure will entail digesting voluminous and frequent reports. On the contrary, it will be found that a competent internal auditor will not trouble a board if everything is in perfect order. It is only when he has serious matters to disclose that he will make a communication, and on such occasions, of course, the directors must give his papers the fullest consideration, no matter how voluminous.

In order that an internal audit shall be efficacious it is necessary that its scope shall not be outlined by any officer whose duties it will control. In other words, the instructions to the internal auditor should be framed by an independent person, preferably the company's auditor in collaboration with the board, or it should be framed by the directors and handed to the company's auditor for approval. The director must therefore be acquainted with many matters appertaining to the internal audit in order that he may assure himself that it is efficient.

Schemes of Internal Audit.

There are many accepted schemes of internal audit in use at the present time, all of which agree in principle. With the actual details of these schemes the director need not bother himself, but he should study the following points in order that he may understand the reason for their adoption and press for their introduction in his own company.

(1) It is unwise to allow cheques to be honoured on the signature of one officer only.

(2) All cheques should be signed by at least one member of the board and countersigned by the secretary, who should produce documentary evidence of their correctness. Long typed lists of cheques do not constitute evidence of the correctness of payments.

(3) All cash received must be banked at once. Petty cash must be drawn from the bank, not reimbursed from customers' cash payments.

(4) All payments over a small maximum must be made by cheque.

(5) The wages book clerk and the wages paying clerk should be different persons.

(6) The duties of the staff should be changed from time to time.

Defalcations usually arise from these sources—

(1) The manipulation of cash receipts from customers.

(2) The diversion of customers' cheques and the closing of their accounts by means of credit notes or transfers to bad debts.

(3) Pilfering petty cash.

(4) The manipulation of wages.

It is to these points then that the director should give his attention. He himself may assist in the internal audit to a considerable extent by insisting on the production of lists of bad debts to be written off, supported by documentary evidence. He should also insist that every member of the staff without exception should take an annual holiday. This is not facetious advice; its object is to cause a break in a series of fraud which must be discovered if the perpetrator's duties are taken over by another member during a holiday. Many frauds have been carried out in the past by the "conscientious, tried and

trusted officer" whose "enthusiasm" for work prevented him from taking respite from his labours for many years. A holiday list should be laid before the board together with a roster of the whole staff. The absence of a member's name from the holiday list will put the director on his enquiry.

Work of Internal Audit Department.

The work which may be entrusted to an internal audit department is as follows. This list could be taken as a basis by a director framing instructions or considering a suggested scheme placed before him for approval—

(1) Purchases and expenses should be verified with invoices or other documentary evidence.

(2) Payments verified with vouchers.

(3) Sales compared with duplicate invoices.

(4) Purchases, sales and material requisitions verified with stock ledgers.

(5) Stocks on hand verified physically with stock ledger balances.

(6) Cash balances counted or verified with certificates.

(7) Ledger control or balancing accounts checked.

(8) Book debts verified and long credit items enquired into.

(9) Bad debts written off and allowances credited, verified with documentary evidence.

(10) Methods adopted for allocating wages, material and oncost charges in the costing records enquired into.

(11) Costing records thoroughly tested.

The official in charge of the internal audit staff should report any serious discrepancy or inefficient accounting and should put forward suggestions for remedying the matter. His report should always

state the ground covered during the audit and the manner in which the accounting is carried out. The directors should compare this report with the programme indicated above and satisfy themselves as to the reasons for the omission of any portion. Any recommendations contained in the report should be carefully considered and definite instructions given thereon.

Investment of Reserves and Control of Investments.

In the previous chapter, which dealt with the balance sheet of a company, it was shown that the reserve fund represented a sum set aside out of profits for the general strengthening of the company's financial position. It must now be stated that reserves are generally divided into three classes, viz., *General Reserve, Reserve Fund and Specific Reserves.* A General Reserve conforms to the description previously given. The reason for its provision is generally that the company's working capital is insufficient to cope with prospective business. The company therefore adopts this method of conserving capital in preference to the more expensive and uncertain one of issuing additional shares or raising debentures. A further reason is that the company desires to stabilize as far as possible the rate of dividend declared each year, adopting this method of setting aside extra profits made in one year against possible reduced profits in subsequent years, but without definitely allocating the reserve to equalization of dividends. Some shareholders may feel disappointed when directors decide to restrict dividends in order to set aside a substantial amount of profit to reserve, but almost every company which has adopted this prudent course has been very thankful when in subsequent

years the existence of this reserve has enabled them to withstand periods of trade depression.

In the case of general reserves, the additional capital thus created is often allowed to remain in the business. If the necessity for its creation was the retention of working capital it may not be possible to spare the cash for outside investment. It is very desirable, however, that whenever circumstances permit, general reserves should be invested outside the business in gilt-edged or trustee securities in order that cash may be immediately available when emergency arises. When a general reserve is invested outside the business it is called a Reserve Fund.

SPECIFIC RESERVES. Specific reserves represent sums set aside out of profits to meet specific expenditure which will be incurred at some future date, e.g. renewal of leases; dilapidations under leases; redemption of mortgages.

It is of the utmost importance that sums set aside for specific purposes should be invested outside the business in gilt-edged or trustee securities, otherwise there is considerable danger that when the occasion arises for the liability to be met there may not be sufficient cash available without completely disorganizing the working capital of the company, thus endangering its financial stability.

Unless the sums so set aside each year out of profits are properly invested in realizable securities the reserve is no more than a general reserve; it will not assist the company to find funds to meet the future liability against which it is an ostensible provision.

Control of Investments.

The supervision and control of the company's investments is a duty devolving upon each member of the board. Where the class of business necessitates

a large number of investments it may be found necessary for a small committee to consider and report whether the investments, as they exist from time to time, are considered suitable. This committee should, however, have no power to act, but only to advise. No investments or changes of investment should be made except by a decision of the full board.

In making investments, the board should be guided by the following rules—

(1) Investment of general or specific reserves should be made in gilt-edged or trustee securities, or in insurance policies.

(2) Except where the business was formed to deal in a particular class of security no investment should be made in an unmarketable security unless substantial trade benefits are thereby acquired.

(3) No unmarketable security in which a director has an interest should be purchased without satisfactory and *bona fide* evidence of the reasonableness of the purchase price.

(4) No investment should be acquired for a purely speculative purpose unless this is one of the objects of the company.

(5) The investments should be shown in detail on the quarterly balance sheet presented to the board.

(6) The secretary and the head of the internal audit staff should certify each quarter that the documents relating to the investments shown on the balance sheet have been produced to them and that they are in order.

These matters deal only with the general investments of a company and do not refer to investments in (i.e. acquirement of) subsidiary companies. This point is of greater importance and must be dealt with in a separate chapter.

CHAPTER IX

THE CONTROL OF BRANCHES ABROAD

It is not possible to lay down the procedure followed in the direction of every class of foreign or colonial branch business. The technical control must necessarily vary with each particular trade. To a certain extent, however, the principles to be followed in the financial direction will be found identical in every company trading in foreign countries.

Merchanting and Producing Companies.

It is first necessary to draw a distinction between those companies whose activities abroad consist of buying and selling commodities and those engaged in the production, manufacture or growing of commodities. In the case of the first it is possible and usual to commit the control of the business to a subsidiary company with a local board of directors. In the case of the producing company it is usually sufficient to place the company's interest under the care of a local manager. The principle class of business placed under the control of a local board is that in which the buying or selling is carried out with natives. It is not possible for a board of directors in England to appreciate the peculiar requirements and conditions attaching to this class of trade to the extent of being able to change a policy with the rapidity so often demanded by circumstances. A local board of directors, on the other hand, is able to exercise local foresight and is less likely to be found unprepared by sudden changes in market conditions. It is not impossible to place this class of trade under the charge of a manager, but whenever

that course is adopted it is absolutely essential to give the representative plenary powers. The company is then committed to the decisions which may be taken from time to time by this one man.

When the branch or station is engaged in producing, then it is usual to appoint a manager only and not a local board of directors. The manager is concerned only with such matters as the purchase of raw materials or the engaging of native labour. The English board is therefore not called upon to relinquish its authority or to delegate its power over vital matters of policy. Trade with the customers is carried on by the English office or by the selling agents under the immediate supervision of the home board. It will be seen that although a local manager is relied upon to carry out a production programme, and is left to his own devices in that respect, the real responsibility remains with the directors. It must be observed, however, that a local manager controlling a plantation or factory abroad must necessarily have a wider scope of authority than that possessed by the manager of a home factory. His appointment is the subject of great discrimination on the part of those delegated to select him.

Whether the immediate supervision of a foreign branch is in the hands of a local board of directors or a local manager, it is essential that the same rigid control of finance should be kept in the hands of the principal directors. The methods by which this is accomplished is set out hereunder.

Local Companies.

The board of a local company is responsible for all routine matters connected with their charge, but upon matters of policy and upon all questions which necessitate the outlay of cash by the parent company the local board consults the principal board. Detailed

balance sheets and trading accounts should be prepared at frequent intervals and forwarded to the head office. The branch company's accounts should be subjected to audit by a local firm of auditors at quarterly or half-yearly periods, and the half-yearly and annual accounts at least should be accompanied by the auditors' detailed report when sent to England.

As the formation of a local board is designed to relieve the home directors of detail supervision, it is not usually necessary to insist upon reports or returns other than those accompanying the accounts and which have been prepared by the local directors and the auditors. This is a matter upon which it is not possible to lay down fast rules. The circumstances must be taken into account and rather more latitude allowed to a competent local board than to one composed of members with whose capabilities and failings the parent directors may not be entirely familiar.

Local Branches.

Control over foreign branches, as distinct from foreign companies, can be maintained only by arranging for complete reports covering the whole of the activities of the branch, to be sent to the head office at frequent intervals. The reports will fall into two classifications—financial and those relating to production or trading. The financial reports consist of monthly summaries of expenditure analysed to show the outgoings on revenue account and on capital account separately. It is usual to provide that no expenditure of a capital nature shall be incurred without express authority from the parent board. It is not possible to apply the same rigid control to revenue expenditure, in which matter the discretion and ability of the local manager must be trusted. An efficient check upon revenue expenditure is, however, provided

by the furnishing of production accounts at monthly intervals by the branch. These accounts are made up to a date to coincide with the period covered by the financial statement and are framed to give the cost of production or trading over the previous month. In the case of branches engaged in plantation it is usual to frame the production accounts to give the cost of production per unit shipped, e.g. per lb. of rubber, and so on. By means of the information provided by the two classes of monthly report it is possible for the directors to watch the expenditure of cash abroad and to take steps to terminate inefficient management without loss of time. It may happen that the company's activities abroad are of such importance that a branch office is required. In such cases the branch may carry out a considerable amount of the actual accounting work and assume a position somewhat similar to that occupied by a local subsidiary company. However much elaboration is introduced, the principle of responsibility to the main board remains and the duty of the parent directors to examine the periodical returns is equally important.

Financing a Branch Abroad.

The first step in the financing of a branch abroad usually consists of crediting a local bank with a sum to cover initial local expenditure on lands and buildings and normal working capital calculated to meet immediate requirements. The local manager is given authority to draw upon this account either upon his own signature, or upon his own signature countersigned by the secretary whenever the payment is greater than the agreed maximum. When production commences, the branch invoices the whole of its output to the head office at cost price and sends forward the production in accordance with instructions from the

sales manager or the secretary. The head office then acts as selling agent or instructs the usual brokers. It is sometimes provided that the branch manager may hand over the documents relating to shipments to the local bank and draw against their value. In this way the financing of the branch becomes more or less automatic. It is not always possible to follow this procedure, however, for it is occasionally necessary to keep all available funds in England. In those cases the head office remits sums to cover the actual requirements of the branch by telegraphic transfer or exchange draft, and the branch sends on the documents relating to shipments direct to the head office. This latter method is also resorted to in order to avoid interest, discount and brokerage. The method to be adopted must necessarily depend upon circumstances and prevailing conditions, among which may be mentioned the variations which occur in rates of exchange between this country and the branch country and the differences in interest charges existing from time to time.

Local Capital Expenditure.

All additional capital expenditure to be incurred by branches abroad should be remitted by the home company and never drawn from a balance of trading capital held by the managers.

Remuneration of Local Managers.

It is customary to remunerate local managers by means of a fixed salary and a percentage on either production or trading profit. This is calculated to induce the rendering of the manager's best efforts in the interests of the company and is a practice which may be adopted with safety. It should always be arranged, whether the manager is remunerated upon profits or

not, that the branch is charged with interest upon the average capital employed abroad. This leads to the remitting to England of all surplus funds without delay and counters frivolous applications for additional capital outlay.

The Local Manager's Returns.

The nature of the information which the director may expect from the managers of branches abroad has been indicated above. It may assist, however, to enumerate the usual periodical returns which should be sent home and laid before the board—

(*a*) Cash expenditure statement analysed under the headings—

(1) Raw material.
(2) Wages.
(3) Expenses in detail.
(4) Salaries.
(5) Capital expenditure as approved.

(*b*) Branch banking account—giving a summary of the bank transactions since the previous return.

(*c*) Branch current account, showing the amounts charged to head office for produce shipped and the amounts credited for cash received.

(*d*) Production account for the period.

(*e*) Stock account, showing quantities held in stock and the transactions in the commodities produced during the period.

(*f*) Costing statement, showing the unit cost of production over the period.

(*g*) Branch trading account and profit and loss account.

The various returns outlined above should be examined immediately upon receipt by the head office officials and then placed before the board. Any further information required should be called for at

once from the manager presenting the returns. It is advisable to pass a communication to the manager upon every set of returns he sends in, even though this communication may amount to little more than acknowledgment of receipt. This display of interest and encouragement cannot but assist the interests of the company generally. Any tendency to treat branch returns with indifference is bound to have an adverse effect upon the zeal and efficiency of the branch.

Special Taxation Points.

It is well for a director of a company possessing branches abroad to know that the trading results of overseas branches of British companies are subject to British income tax notwithstanding that local taxation may already have been borne. If the branches are situated in British Dominions, however, a measure of relief is provided which has the effect of reducing the rate of combined tax paid both at home and in the Dominion to the higher of the two rates in force in either Great Britain or the Colony.

If the foreign branch is a joint stock company controlled by a local board then the profits will not ordinarily be subject to British income tax. Tax will be payable upon any dividends received by the parent company from the subsidiary abroad.

Directors of companies possessing mills and factories abroad should note that their companies are entitled to a deduction from the company's profit of a sum equal to one-sixth of the gross annual value of the factory calculated in a similar manner to that followed in England for this purpose. There is a proviso attaching to this concession, namely, that the buildings to which it applies must have power-driven plant installed therein.

Commercial Agency System.

Before leaving the matter of branches abroad reference must be made to a system whereby many companies manage their foreign properties through agents. The method is known as the commercial agency system. It is in common use among rubber, tea and similar planting companies and consists of committing the destiny of the companies concerned to firms of agents who have a house in London and one in a port abroad.

The system has many advantages and many disadvantages which are admirably set out in a recent speech by Mr. D. F. L. Zorn (Chairman of the Rubber Shareholders' Association), a gentleman of great experience with this class of company—

"The system has grown up gradually during the last 30 years and in a great many cases works successfully, but there are certain directions in which it is possible for serious abuses to creep in, partly because there is frequently a stringent agreement under which the planting company is bound to the agents for a fixed term of years. The broad criticisms made against the system are: firstly, there is a tendency for the commercial agents to usurp the functions of the London board of directors and the estate manager. Secondly, that as the agent in the East usually holds full power of attorney, the estate manager is dependent for his position on satisfying, not the owners of the estate, but the agent representing those owners, which is by no means the same thing. Thirdly, that it not infrequently happens that gentlemen who are partners in an agency firm acting for a particular company also sit as directors upon the board of that company. Sometimes these agent directors constitute an actual majority of the board."

The director who accepts a seat on the board of this class of company should pay careful heed to these

points. The commercial agency system is one by which directors may easily become mere figureheads unless they grasp the real control and retain it firmly. There is no real analogy in any other class of company except perhaps in the shipping industry, in which the control of a line of vessels is committed to a firm of managers. A directorship in this industry calls for equal caution and self-assertion.

CHAPTER X

DIRECTORS AND PROSPECTUSES

THE duty of a director with regard to a prospectus is not only one of the most important of his duties but is also frequently one of the first. We have deferred dealing with the matter until now, however, because this chapter will deal with the practical side of a prospectus and not merely the legal details surrounding its issue. The discussion of the practical questions of prospectus issue presupposes a knowledge of accounting principles, and it has been necessary, therefore, to leave this point in the duty of a director until the accounts of a company had been set out and explained.

The Companies Acts, 1908-1917, devote considerable attention to prospectuses, and many sections are included for the protection of the public from the dangers besetting them when they are induced by advertisements to invest money in companies concerning which they have no information beyond that provided in a prospectus.

No public company can allot shares or debentures, whether originally offering shares to the public or not, until it has filed with the Registrar of Joint Stock Companies a copy of its prospectus or a statement in lieu of prospectus. The prospectus must be signed by every person named in it as a director or prospective director, it must be dated, and every copy issued or published must state that a copy has been duly presented for registration. It is the duty of every director named in a prospectus to see that a copy has been so filed, for neglect carries with it a liability to a fine of five pounds per day from the date of issue until the eventual date of filing. (Sec. 80.)

Contents of the Prospectus.

Sec. 81 of the Act lays down a long list of detailed information which must be given in prospectuses; directors would be well advised to study this section carefully when checking over a draft prospectus handed to them for approval before publication. The principal matters which must be disclosed will be discussed below.

The contents of the Memorandum with the names, description, and addresses of the signatories and the number of shares taken by each of them, and the number of founders' shares with details of the holders' interest in the property of the company, must be set out in full. This requirement, however, is not necessary when the prospectus is issued as a newspaper advertisement, or when the prospectus is issued more than one year after the date at which the company became entitled to commence business. The qualification, names, descriptions, remuneration and addresses of directors must be given, except under the last circumstance mentioned in the preceding paragraph. The minimum subscription upon which the directors will proceed to allotment must be stated, and in the case of a second or subsequent issue the prospectus must give the amount previously offered within the two preceding years, the amount allotted, and the sum paid up on the shares allotted. In all prospectuses issued within one year of a company becoming entitled to commence business it is necessary to give an estimate of the amount of the preliminary expenses.

Minimum Subscription.

Directors should be particularly careful to observe their duty with regard to the minimum subscription. Even if the issue has been underwritten the prospectus

must state the amount upon which the directors will proceed to allotment. It must also disclose the amount payable on application and allotment and give details of the success or failure of previous issues during the preceding two years. Occasionally directors may find themselves faced with an action commenced by underwriters if the latter have relied upon statements contained in a draft prospectus which afterwards prove to be misrepresentations. In this connection, however, it may be noted that the underwriters have no relief if they sign their underwriting letters merely on the strength of the characters of the directors responsible for the issue. It is unwise to fix the minimum subscription at a lower figure than the amount actually required for the purposes set out in the prospectus unless that sum has been satisfactorily underwritten. Many recent failures may be attributed to attempts to carry on companies with the cash provided by meagre responses to appeals for working capital. It is a far more satisfactory course to refrain from proceeding to allotment unless the actual subscriptions amount to the sum required, irrespective of whether the minimum subscription has been stated at a much lower figure. If the minimum subscription is not obtained, then the moneys must be returned as provided by Sec. 85. The duty of a director in this matter is morally greater than that laid down by statute. Prior to the Act of 1900, directors were able to proceed to allotment even when a very small and insignificant amount of capital had been subscribed. The 1900 Act had for its intention, *inter alia*, the prevention of this practice, but obviously it was impossible to lay down an amount below which allotment should not take place. It rests entirely upon the directors to observe the spirit of that Act as embodied in the Consolidation Act of 1908.

Vendors.

The names and addresses of the vendors of any property purchased or acquired, or proposed to be acquired by the company, must be given in the prospectus if the property is to be paid for wholly or partly out of the proceeds of the issue. This requirement is a most important one, and must be observed in the spirit as well as in the letter. Not only is it necessary to disclose the names of the actual vendors, but also those of sub-vendors, and the consideration payable to each in cash, shares or debentures. Another sub-section of Sec. 81 further provides that a prospectus must set out the number of shares or debentures which have been issued otherwise than for cash during the preceding two years and the consideration for which the issue was made. The amount paid or payable as purchase money for property must be given, and it is obligatory to state separately the amount paid or payable for goodwill. Any payments to a promoter during the two previous years must be disclosed, and reference must be made to all material contracts which have been entered into during the preceding two years, whether with promoters, vendors or other persons.

The Purchase of Property.

It is in connection with the purchase of property from promoters or vendors that the director is bound to exercise particular vigilance. He may be perfectly satisfied with the price paid by the company for the property, but when checking the draft prospectus he should insist upon seeing the originals or certified copies of all the contracts leading up to the sale. The person who completes the last contract for sale with the company is not always the only vendor within the meaning of the Act. The word includes any person who

has entered into a contract, either absolute or conditional, for the sale, purchase, or option of purchase, of any property to be acquired by the company if the purchase money has not been fully paid at the date of the issue of the prospectus or if the purchase money is to be paid wholly or in part from the proceeds of the invitation to the public, or if the contract depends for its fulfilment on the result of the issue. It will be observed then, that if A agrees to purchase the X works as a going concern, and pays a deposit on the purchase one month before the prospectus, the balance to be paid two months after the public issue, and then agrees to give an option to B to buy within two months, and B sells his option to C, who enters into an agreement with the company to sell the works for cash payable one week after the issue, all these people are vendors within the meaning of the Act. The interest of each, the name and address of each, and the manner in which they are to be paid must be disclosed to the public. The object of the provision is naturally to ensure that the public is made aware of the circumstances under which a company to which it subscribes pays £1,000,000 for a concern which was sold to a sub-vendor for £500,000 but two months previously. Occasionally a company purchases only a lease of a factory instead of buying a concern outright. The fact that the lessor does not receive "purchase money" and does not sell his property will not excuse the company from disclosing the name of the lessor or sub-lessees in the same manner as the names of vendors would be disclosed.

Directors' Interest.

The section is equally emphatic on the disclosure of directors' interest as on the statement of vendors' consideration. It is necessary to give details of the nature and extent of the interest of any director in

the company's promotion or in property to be acquired, with a statement of the sums paid or payable to him in cash, shares or otherwise to induce him to become a director, or to qualify him as a director, or in payment of services rendered to the company by him or by his firm.

The clause dealing with directors' interest is a wide one and was introduced to strengthen the common law liability, which prevented a director making a secret profit but allowed him to take his profit on disclosure of his interest to independent directors. The Act now provides for disclosure in the prospectus itself.

Occasionally directors lend their names to promoters of companies, who use them to enhance the chances of success of the issue. The section relating to directors' interest covers this matter and requires disclosure in the prospectus of the cash, shares or consideration paid to a director to induce him to take a seat on the board. This should act as a deterrent to directors who may be tempted to lend their names to promoters for prospectus purposes or for assisting appeals to the public for capital for concerns in which the use of the promoter's own name alone might prove a hindrance rather than an inducement.

Voting Powers.

If the company is formed with different classes of shares the rights and voting powers attaching to each class of shares must be given.

Reports and Documents.

There are several other minor matters which must be set out in the prospectus, but as they are not of so great importance as those set out above, the reader will not be worried by their iteration. Attention

must be paid, however, to other matters which promoters are anxious to disclose as distinct from those which must be revealed under pain of penalty. Strangely enough, the Act is practically silent on all the matters to which most of the space and large type in prospectuses is devoted. There is no obligation, for instance, to set out past profits, experts' reports, directors' forecasts of future profits, valuation of property, particulars of patent rights, testimonials or descriptions of the company's processes. Incidentally, there is also no obligation to set out a company's past losses. There is no objection to the provision of any information of the nature of the foregoing, in spite of the fact that it is not legally necessary to give it. Directors should, however, be at least as careful in the scrutiny of gratuitous information as in the verification of information they are bound to include. It is recognized, of course, that due allowance must be made by the public for enthusiasm, sanguine hopes, and even exaggeration on the part of promoters. It is essential, however, that there should be no misstatements or concealment of any matters of importance. If a shareholder is induced to join a company by misrepresentation he has a right to rescission of the contract, and he may also have a right to action for damages against every person who has assisted in the issue of the prospectus. Sec. 84 provides for damages against directors or any other persons who have aided misrepresentation or who have sanctioned the inclusion of the reports of experts when they themselves had no reasonable ground for believing them to be true. This section is an important one, for it re-enacts the Directors' Liability Act of 1890, which lays down that an applicant for damages need only show that the statements complained of are untrue, the onus of proving that there were reasonable grounds

for believing the statements resting upon the directors or other defendants.

The directors must not only examine each paragraph of a proposed prospectus, but they must grasp the general import of the document as a whole. It may happen that each point, taken separately, could be justified and yet the whole prospectus remain a misrepresentation. On this point the case of *Aaron's Reef* v. *Twiss* (1896) laid down that the true test is—"taking the whole thing together, was there misrepresentation? If a number of statements give a false impression, the prospectus is none the less false, although it may be difficult to show that any specific statement is untrue."

Occasionally a prospectus is misleading on the whole on account of the suppression of information which would throw a different aspect upon the statements actually published. In such a case there is undoubtedly misrepresentation for "those who issue a prospectus, holding out to the public the great advantages which will accrue to persons who will take shares in a proposed undertaking and inviting them to take shares on the faith of the representations therein contained, are bound to state everything with strict and scrupulous accuracy and not only to abstain from stating as fact that which is not so, but to omit no one fact within their knowledge the existence of which might in any degree affect the nature or extent or quality of the privileges and advantages which the prospectus holds out as inducements to take shares" (*Kindersley V.C. New Brunswick and Canada Rail Co.* v. *Muggeridge*, 1859).

Auditors.

The names and addresses of the auditors must be given, if any have been appointed, but there is no

obligation to publish auditors' certificates as to past results, a matter to which reference will be made shortly.

Auditors' Certificates.

The certificates of auditors are frequently inserted in the body of prospectuses whenever the past results have been gratifying. It is usual to request the company's auditors to re-cast their previous annual certificates or to provide a certified *résumé* of the past results, but occasionally an independent firm is instructed to draw up a report based upon the audited accounts. The exact effect of these certificates upon the prospectus as a whole must be carefully examined by every director or proposed director. Naturally, the report will be drawn up in accordance with the specific instructions of the promoter or one of the directors. It is useful to procure a copy of the instructions so given, for although a report from the auditors will undoubtedly follow out the instructions given, it may not give the type of information which is due to the investing public. On no account should a director acquiesce in the suppression of any portion of an auditor's report for prospectus purposes, and he should never be a party to the common practice of inserting a director's or promoter's report in which quotations only are given from an auditor's report. If auditors have been requested to give a report for a prospectus, then no one has any right to use it except as a report in the body of the prospectus. In order that the director may recognize any instance of this deplorable practice, an illustration of the method by which it is accomplished is given below—

The Auditors' Report to the Managing Director or Promoter—

Dear Sir,

In accordance with your instructions we have examined the accounts and books of your Company over a period of

seven years, ended 31st December, 1923. The profits of the Company, after providing for debenture interest, depreciation, and Directors' fees amounted to—

Year ended 31st December,	1917	. .	£44,945
,, ,,	1918	. .	£56,765
,, ,,	1919	. .	£59,772
,, ,,	1920	. .	£76,897
,, ,,	1921	. .	£132,545
,, ,,	1922	(Loss)	£634
,, ,,	1923	. .	£48,634
Average over seven years		. .	£59,846

With regard to the postscript in your letter of the 18th inst., the total amount charged during the past four years for Directors' fees and depreciation was £67,024.

We are,
Yours faithfully,
A. B. and Company.

Copy of letter contained in the Prospectus from the Managing Director to an Investment Company, acting as the issuing house for the Company—

Dear Sirs,

With reference to the purchase by your Corporation from this Company of 500,000 7% Cumulative Preference shares and 200,000 5% First Mortgage Debentures, I beg to give you the following information concerning the Company—

The Company was incorporated on etc., etc.

Messrs. A. B. & Co. have examined the books of the Company and have furnished a certificate of the profits which, after making adjustments for Directors' fees and depreciation, shows that the average profits over the past four years have been £76,602 per annum.

Etc.

Yours faithfully,

The above illustration is purposely exaggerated in order to show the method followed whenever this practice is resorted to. It will be observed that the auditors' report makes no reference to any figure similar to that quoted. The figure given has been made up by selecting prosperous years and adding back charges which should be left in the accounts as outgoings.

The wording of a portion of a letter which recently appeared in a prospectus offering debentures was as follows—

> According to the audited accounts the profits of the Company, after making adjustments for non-recurring items of income and expenditure, but before providing for depreciation and interest on loans were . . .

This extract which has been copied from an actual prospectus serves to illustrate further the method explained in the previous example. It will be realized that a sentence of this nature can cover adjustments of a magnitude equal to those used in the fictitious example, and which increased the average profits from £59,846 to £76,602. But this extract is quoted for another reason. The attention of the reader is directed to the words "after making adjustments for non-recurring items." In the first place, it must be pointed out that it is quite correct in principle to exclude certain non-recurring items, but this task is one which should be left to the auditors if their figures are to be used in connection with the prospectus. If the promoters wish to use their own figures then they should not endeavour to bolster them with vague reference to "auditors' reports" or to "audited accounts." They should stand or fall by their own figures. If, on the other hand, the promoters wish to use the report supplied by a firm of accountants then it is an incorrect, a discourteous and almost unmoral practice to make adjustments to the figures without giving an opportunity for the expression of an opinion by the accountants concerned. It may be advanced that the directors or promoters accept the responsibility, and that the fact that adjustments have been made is disclosed in the wording of the directors' letter to the issuing house or in the general statement of information given by the promoters.

This attitude is certainly one which might be maintained in any subsequent proceedings under Sec. 84, but it is not one which can be maintained with honesty by those in whom the shareholders are placing their trust.

The fact that depreciation, directors' fees, or some similar charge against profit, is added back and referred to as " necessary adjustments " is only significant to such of the general public who know the difference between " charges against profit " and " appropriations of profits " and only then to those who are astute enough to realize that the adjustments have been made to show sufficient cover for the interest or dividend on the security offered for subscription. It must be admitted that the proportion of average investors who are able to calculate roughly the depreciation charge from any particulars of the fixed assets given in the prospectus, is very small. The proportion who can form an approximate idea of what the profits were before the adjustments were made is smaller still. The vast majority will never take the trouble, and whenever information as to profits is given by the directors or promoters "supported " by a comforting reference similar to the one quoted above—" according to the audited accounts "—then little blame can attach to the investor who is very often shamefully hoodwinked by these subtle methods.

Adjustments of Profits.

As mentioned above, there are many items appearing in the published accounts of a company which correctly fall to be adjusted. The adjustments should be left to the accountants preparing the certificates although it is in order for the directors to give special instructions for the elimination of exceptional items. In that case the accountants will follow the instructions

given, but they will include a statement drawing attention to the special adjustments in their report. This right of the accountants is unassailable, and their report must not be interfered with. It is well then for the director to be clear on the principles governing legitimate writing back, or adjustments of profits or charges. He will then be in a position to decide whether his colleagues are justified in giving special instructions to the accountants on the matter of any particular adjustment. Firstly, the object of a statement of past profits is to let the investor know what amount of money is likely to be available for dividends on the shares for which he is subscribing, during the succeeding years. Statements of past profits are naturally a better guide to him than unsupported and vague forecasts prepared by interested parties, promoters, vendors and so on, and they have the advantage of being certifiable.

If the preparation of the certificate of past profits is left entirely to the discretion of the accountants, then they will follow the usually accepted principles governing adjustments. They will examine each of the items which have been credited to, or charged against, profit and loss account during the period under review, and they will add back or deduct any items which are not ordinary trading charges or trading profits. Exceptional profits of a non-trading nature which are not likely to recur will be excluded. Where secret reserves have been created by excessive depreciation they will adjust the charges to normal amounts. In every case they will indicate clearly the nature of the adjustments they have made.

In addition to these alterations, the accountants will exclude any charges incurred in the past which will be eliminated as a result of the issue of fresh capital, even though these items are ordinary trade

charges properly debited to the profit and loss account. Thus, where the proceeds will be used to extinguish a bank overdraft the amounts previously charged for bank interest will be correctly added back in arriving at the distributable profits under the new conditions. Again, if certain debentures are to be paid off out of the proceeds of an issue of shares, it is correct in principle to add back the debenture interest which has been charged in the previous accounts. In the case of the conversion of a partnership business into a limited liability company, the accountants will add back any salaries of the partners which have appeared in the previous accounts. On the other hand, adjustment will be made to allow for the directors' fees, which will be payable instead of salaries to partners. Sometimes the cash received by means of a new issue is applied to the purchase of property previously rented. If this is so, then the rent charges of former years will be added back to the profits in the certificate. Losses on stock have been fairly common during recent years. It has been a generally adopted practice to ascertain the total loss and write down the stock in one year in the ordinary annual accounts. It is incorrect for prospectus purposes, however, to allow the total loss to remain in the year in which it was written off and to exclude that year from any averages struck. This practice was recently adopted in a prospectus, but the example is not one to be followed, for it gives rise to fallacious statistics and is reprehensible in the extreme. The loss was due to a fall in prices, which was relatively a gradual process, and certainly not attributable to one year only.

An Example of Adjustments.

In order to illustrate the method of adjusting profits for prospectus purposes, as detailed above, an example

PROFIT AND LOSS ACCOUNTS

	Year 1	Year 2	Year 3	Year 4	Year 5
	£	£	£	£	£
To Office and Travellers' Salaries and Expenses	89,640	91,380	93,420	94,110	92,876
,, Rent of Premises	5,000	5,000	5,000	5,000	5,000
,, Directors' Fees	7,200	8,000	8,000	8,000	9,450
,, Rates, Taxes, and Insurance	1,750	1,890	1,940	1,970	2,110
,, Audit and Accountancy	850	850	850	900	900
,, Legal Expenses	530	620	483	550	3,970
,, Expenses *re* Key Industries Bill	—	—	520	1,960	—
,, Bad Debts	7,980	6,980	8,290	9,480	25,720
,, Lighting, Heating, and Cleaning	1,420	1,375	1,240	1,850	1,740
,, Donations and Subscriptions	575	620	490	385	360
,, Bank Charges	132	150	149	128	117
,, Bank Interest	2,500	3,400	3,900	2,780	2,550
,, Depreciation—					
Plant and Machinery	7,420	8,960	8,840	8,590	9,200
Fixtures	838	921	724	639	678
Office Furniture	320	310	290	280	255
Tools	480	460	430	390	370
,, Repairs and Renewals	1,100	990	840	730	850
,, Interest on Debentures	5,000	5,000	5,000	5,000	5,000
,, Pensions and Annuities	1,000	1,200	1,100	1,300	1,250
,, Compensation to late Managing Director	—	—	5,000	—	—
	£133,735	£138,106	£146,506	£144,042	£162,396
To Net Profit	25,670	34,300	29,870	28,640	32,487
	£159,405	£172,406	£176,376	£172,682	£194,883

	Year 1	Year 2	Year 3	Year 4	Year 5
	£	£	£	£	£
By Gross Profit from Trading Accounts	150,490	163,136	157,297	137,969	190,549
,, Interest on Overdue Accounts	175	240	59	63	184
,, Indemnity from Insurance Company	—	—	15,300	30,700	—
,, Discounts Received	3,940	4,230	3,720	3,950	4,150
,, Agency Commissions	4,800	4,800	—	—	—
	£159,405	£172,406	£176,376	£172,682	£194,883

is given on page 113, consisting of the summarized results of a business over a period of years, and an account of the profits as they would appear after adjustment based upon the information given concerning the proceeds of the issue.

THE A. B. COMPANY, LIMITED

An issue of 200,000 Ordinary Shares at par, bringing the Authorized and Issued capital up to £400,000.

The proceeds will be devoted to paying off £100,000 5 % Debentures, a Bank overdraft of £50,000 and the purchase of the premises occupied, for which a rent of £5,000 per annum is at present payable.

The profits in the example given, if adjusted for prospectus purposes would be as follows—

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
	£	£	£	£	£
Profits as per Accounts	25,670	34,300	29,870	28,640	32,487
Add back the following charges—					
1. Rent of Premises .	5,000	5,000	5,000	5,000	5,000
2. Legal Expenses (connected with special lawsuit)	—	—	—	—	3,500
3. Expenses *re* Key Industries Bill . .	—	—	520	1,960	—
4. Bad Debt (special non-recurring) . .	—	—	—	—	16,000
5. Bank Interest on Overdraft . . .	2,500	3,400	3,900	2,780	2,550
6. Interest on Debentures	5,000	5,000	5,000	5,000	5,000
7. Compensation to Managing Director	—	—	5,000	—	—
	£38,170	£47,700	£49,290	£43,380	£64,537

It will be observed that the adjustments have the effect of showing the profits at the amounts which will be available for the new shareholders, all other circumstances being equal. The rent of premises will not be chargeable against the profits in future, and the

item is therefore excluded. The special legal expenses (£3,500) and the bad debt (£16,000) were connected with a lawsuit over the quality of certain goods which were alleged to be faulty and were so found by the Court. It is unlikely that so large a sum will be lost under similar circumstances in the future, and there is no obligation to provide for such a contingency. The two sums are therefore added back. Bank interest and debenture interest will disappear when the new capital is subscribed. None of the profit items has been added back, but reference would be made to the fire which occurred in Year 3 and a statement of its effect would be furnished. The indemnity received fron the insurance company is regarded as a replacement of the profit which would have been made on the burnt stock.

The profits before and after adjustment are therefore as follows—

	Before Adjustment	*After Adjustment*
	£	£
Year 1	25,670	38,170
,, 2	34,300	47,700
,, 3	29,870	49,290
,, 4	28,640	43,380
,, 5	32,487	64,537
	£150,967	£243,077
Average per annum	£30,193	£48,615 Or, approximately, 12% on Capital.

Publication of a Balance Sheet.

There is no statutory obligation to publish the company's balance sheet in the prospectus, but whenever a balance sheet is given in a prospectus, the directors should see that it is printed in the form in which it was presented to the shareholders at the last meeting. There is a practice now extant

of providing the public with an uncertified statement resembling a balance sheet in certain particulars only. Very often a valuation figure taken from a valuer's report is inserted against the fixed assets and directors' estimates against the floating assets including investments temporarily held for trading purposes. Whilst the inclusion of a valuer's report and figures in a prospectus is a practice to be commended, it is incorrect to endeavour to use it in making up a balance sheet which probably differs from that presented to the shareholders. A little reflection will convince the reader that this practice quite naturally arouses suspicion that the balance sheet contains undesirable items, the amount of which is covered by an excess of the valuation of fixed assets over the book values. If this practice is adopted in the case of a company which makes no reference to past profits or dividends then the public cannot be blamed for suspecting that the balance sheet contains a debit balance on profit and loss account as one of its assets.

Issuing Houses.

Most of the issues of new capital are now carried out through the medium of issuing houses and trust companies. Sometimes the issuing house purchases the issue and re-sells at a profit; in other cases, the issuing house merely acts as an agent, placing the underwriting and carrying out the work for an agreed fee. There is no objection whatever to this form of appeal for fresh capital, but any director connected with a company intending to adopt this method would be well advised to adopt the following recommendation. He should treat the appeal issued by the investment or trust company as one published by himself, verifying the information given therein

and insisting upon having the prospectus or circular submitted to him for approval. If a director carries out this advice he will be doing more than is imposed upon him by the Acts, but he will be acting fairly towards the prospective shareholders for whom he will shortly become a trustee.

The reason for giving this advice will be found by comparing the wording of Sec. 285 of the Act, which defines a prospectus and contains the sentence "offering to the public for subscription *or purchase* any shares," with the wording of Secs. 80, 81 and 84, which contain very different phrases.

This is not the place to explain the exact significance of the various wording of the sections dealing with prospectuses, and attention is drawn to an opportunity for evading the law only in order to emphasize the moral duty resting upon the director who is a party to a contract with an issuing company. By insisting upon the production of all advertisements intended to be issued by a purchasing company, the director will be able to see that correct information only is given and that advantage is not taken of the fact that the public are invited to "purchase" and not to "subscribe."

CHAPTER XI

THE PURCHASE OF NEW BUSINESSES

THE negotiations which precede the amalgamation of companies, absorption of subsidiaries and the complete purchase of ancillary businesses are so involved that their treatment could only be dealt with adequately in a separate volume. The part which directors usually play in these matters is often less than it might be, rather too much being left to the solicitors and accountants of the respective companies. Though an amalgamation will often be carried through on more advantageous and mutually satisfactory terms if it is left entirely to the only people who understand the principles involved, it should not be thought that it is only the solicitors or accountants who are bound to understand the details of the scheme. The fact that many directors merely grasp the general outline of a suggested purchase, amalgamation or absorption, and give their consent because they are recommended to do so by the company's advisers, is no reason why a practical director should not endeavour to make himself acquainted with the methods by which such transactions are effected. It is insufficient, for instance, to have only a hazy idea of the meaning of goodwill in purchase transactions. The director should be acquainted with the methods by which a value is placed upon this and other assets. He will not then be induced to agree to a purchase of a business at a round figure—apparently reasonable—without satisfying himself that value is received for any cash transferred against intangible assets.

The Purchase of Small Businesses.

The reader is asked to bear with us awhile in order that we may deal with a matter which affects the small financier who is requested to invest his savings in more or less insignificant concerns in return for employment and a seat on a board. The word "insignificant" is used to denote small businesses which might, from the point of view of capital, be quite conveniently carried on in partnership. It is not used in a slighting manner towards small concerns possessing valuable fields for their particular business and requiring only a little capital to render their success assured. Unfortunately, however, this class of company is made up, to a considerable extent, of risky one-man concerns with little past history capable of courting enquiry, and with little prospects of a successful future.

A good deal has been written concerning this type of concern, but the following summary of advice will bear repetition for the benefit of any reader who is seeking employment for his spare capital and leisure moments, and who is tempted to cast in his lot with such a company—

(*a*) Companies offering a salaried post as director or secretary in return for an investment of a comparatively small sum of money should be regarded askance.

(*b*) The would-be director is unwise to trust to his own perspicacity in sifting the information given to him by owners of such small concerns.

(*c*) The services of an independent investigator should be employed. He will probably delve for information not readily available and ignore that given gratuitously.

(*d*) A director investing his money in a one-man company recently founded and with no tangible proof

of prospects should realize that he is indulging in a speculation and that he has only himself to blame if he loses his money.

Generally speaking, observance of these maxims will lead to the saving of money, and their non-observance will aid in money's speedy disappearance. If the concern has been in existence for some time, then an independent investigation and report is absolutely essential. If it is newly founded, then the investor who is offered a seat in return for his money must use his discretion and acquire as much independent advice as he can command. If the company is formed for the exploitation of a new process or patent, then technical advice should be sought. If the object of the concern is a business conflicting with the laws of a nation, such as whisky-running to the United States, then the less the investor has to do with the proposal the better. Companies which set out to acquire huge tracts of rich oil-bearing land with the magnificent sum of one thousand pounds or so should be left to their own devices. The oil they promise to raise will speedily place them in funds and render them independent of the small premium they require from an intending director or secretary.

Absorption of Companies.

The absorption of companies by other companies may be carried out in many ways, the principal of which are—

(1) The complete purchase of the assets.

(2) The purchase of the issued share capital.

The term "complete purchase of the assets" is used to apply to businesses previously carried on by a sole trader or a partnership, as well as to companies incorporated under the Companies Acts. In the case of the former, the transaction is no more than a simple

purchase on terms agreed to by the vendor and the purchasing company. In the case of the acquisition of the assets of a company by complete purchase, there are many formalities of company law to be observed, including possibly the liquidation of the purchased company. Absorption of companies by purchase of the issued share capital differs from complete purchase in that it does not pre-suppose the formal liquidation of the vendor company. The latter continues as a separate constitution, and the real effect of the amalgamation is that its shares have changed hands and that control is transferred to the majority shareholder—the purchasing company. The effect of the principal sections of the Companies Acts dealing with the complete purchase of the assets of a company may be set out briefly as follows—

(*a*) The vendor company must follow the procedure laid down in Sec. 192. This section provides for the liquidation of the company, the realization of its assets for cash or for shares in the purchasing company, and the transference of the business to a liquidator.

(*b*) The liquidator may, with the support of a special resolution, receive in compensation for the sale of the assets, any shares, policies or similar interest in the transferee company and distribute such compensation among the vendor shareholders.

(*c*) Such an arrangement made by the liquidator is binding upon the members of the transferor company.

(*d*) Any member who did not vote on the special resolution, however, or any dissentient to the resolution may require the liquidator either to abstain from selling or to purchase the dissentient's interest at a price fixed by agreement or arbitration.

(*e*) The liquidator must pay such price to the dissentient before the final dissolution of the company.

(*f*) The contract for sale will specify whether the creditors are to be taken over by the purchasing company or paid off by the liquidator.

There are no special points of law connected with the alternative method, viz., the purchase of shares. It is therefore possible to proceed with the consideration of the practical points involved without reference to the statutes.

Fixing a Purchase Price.

As soon as tentative proposals for a purchase have been made, it is usual for the two companies concerned to instruct their respective accountants to commence an investigation with a view to recommending a purchase price. This work is carried out without prejudice to subsequent negotiations and is in fact only a preliminary to the real transactions to take place at a later date. As, however, the recommendations of the accountants may subsequently be used as a basis for the purchase, the reports presented to the board must be thoroughly understood.

Purchase of a Going Concern.

When a company intends to purchase another going concern outright, it is first necessary to fix a date upon which the purchase shall take effect. The fixing of this date may affect many important aspects of the transaction. It may be agreed, for instance, that all liabilities up to the purchase date shall be satisfied by the vendors. Again, it may be agreed that the purchasing company shall take the benefit of profits accruing from the agreed date, in which case an apportionment of profit must be made.

The chief points governing the fixing of a purchase price are four in number, of which two concern the accountants in the first place, one the valuers and

one the directors. The final decision of course rests with the respective boards. The points are—

(1) Valuation of the assets other than goodwill.

(2) The investigation into the past profits and the assessment of goodwill.

(3) The ascertainment of the liabilities.

(4) Consideration of the future of the purchased company and the prospects awaiting its products under the new arrangement.

Valuation of Assets.

Fixed assets such as plant, machinery, furniture, fixtures and fittings, are usually valued by firms of valuers appointed by the two companies. The directors should make it their business to enquire whether obsolete machinery has been excluded and that full regard has been paid to any contemplated change in the nature of the business to be acquired. Investments in quoted securities will be tentatively valued by the accountants from official lists. Investments in subsidiaries or in private companies for the shares of which there is no quotation will usually be valued from such data as is available, by mutual arrangement between the two firms of accountants engaged.

The valuation of patent rights, trade marks and similar assets is not governed by any set code of procedure. Full regard must be made to the unexpired terms of all patents but the value can usually be agreed upon only by the directors or by such agents delegated to represent the companies with complete knowledge of the intentions of the board concerning future policy. No little responsibility rests upon the directors in the valuation of this class of asset, and it is imperative that they should devote as much time and consideration to the question as possible before agreeing to pay any price suggested by the vendors. Book

debts will usually be valued by the accountants in consultation. Reserves for discounts to be allowed on book debts must be taken into account; reserves for bad debts must be deducted, unless the vendor company agrees to the more satisfactory course of guaranteeing the debtors. Stocks on hand should be valued by valuers experienced in the particular class of business concerned. All out-of-date, old, unsaleable or unfashionable stock should be excluded, and for this purpose the directors should ask to see the stock schedules when considering the final proposals.

Past Profits and Goodwill.

The price to be paid for goodwill cannot be fixed by such methods of valuation as are employed for other assets. Goodwill may be defined as the value of a reputation for a class of goods or services built up by means of satisfaction accorded to customers, with the probability that the public will continue to buy those goods if the same methods of manufacture, branding and advertising can be used by the purchasers of the business. There is also a certain class of goodwill attaching to the personality of the owner of goods, often independent of the quality of his supplies. This goodwill frequently and quite naturally disappears when the business changes hands and the personality holding the public's goodwill retires from the scene. Another class of goodwill depends upon position of the place of business. A hotel company may, for example, possess a valuable goodwill from the fact that its property adjoins a railway station. The diverting of the railway or the closure of the hotel lease, causing removal to another site, destroys the goodwill or lessens its value. As distinct from the goodwill attaching to goods the other two classes

will be referred to below as personal goodwill and local goodwill respectively.

Valuation of Goodwill.

It must first be ascertained whether the asset goodwill, though an intangible one, is likely to pass to the purchasing company without serious deterioration and without risk of falling seriously in value from causes outside the power of the purchasing board. In order to determine this point the directors must examine the following points—

(*a*) Is the goodwill dependent upon a patented article, of which the term of the patent is practically expired ?

(*b*) Is it dependent upon a craze or caprice of the public which is likely to die out or become unfashionable ?

(*c*) Does it owe its value to a commodity which does not completely fulfil the public requirements, and is it likely to be superseded by improved processes and inventions ?

(*d*) If the goodwill is dependent on personal factors, will the purchasing company be in a position to retain the personal services concerned ?

(*e*) If it relies upon locality and position, can the premises be purchased, or will a favourable lease be transferred ?

According to whether these matters are favourable or not, a valuation based on a number of years' purchase will be fixed.

Years' Purchase.

The purchase price of goodwill usually varies from two to seven years' purchase calculated by multiplying normal average past profits by the agreed number of years.

Average Normal Past Profits.

Average normal past profits are arrived at by first ranging in comparative form as many of the profit and loss accounts of the business to be acquired as possible. An investigation—and sometimes an audit—is then carried out with a view to ascertaining the policy adopted in the compilation of the accounts, and the methods followed in the disposition of reserves, creation of funds, depreciation of assets, and economy in administration. The principle to be followed accords with that adopted in the adjustment of accounts for prospectus purposes, i.e. non-recurring charges and profits are eliminated, excessive depreciation is written back, allowances are made for secret reserves, and profits arising from such abnormal circumstances as war contracts are excluded. It is not considered necessary to set out further examples of adjustment of accounts as they have been given in the chapter dealing with "Directors and Prospectuses."

When the profit and loss accounts have been recast, an average is ascertained and the negotiators agree upon a number by which this average must be multiplied. It must be remembered that the purchasing of goodwill depletes cash and raises an intangible asset, which becomes worthless if the fortunes of the purchased company do not turn out as satisfactorily as the vendors foretell. The directors should therefore exercise more care in the purchase of this asset than they would in the case of a tangible one. They should be particularly careful in the examination of a proposal to include in goodwill at an extra price the benefits of doubtful or untried contracts, concessions or agencies.

It frequently happens that items of this nature account for the whole of the asset goodwill when the

purchased company has no past profits upon which to base the asset. This burden upon companies was one frequently encountered during the immediate post-war years, but the instances in which newly founded companies have purchased untried subsidiaries possessing goodwill accounts, are gradually becoming fewer. There was, at that period, a regrettable tendency to pass cash for concessions, rights and untried patents upon the slightest representations of the vendors.

Payment for Goodwill Otherwise than in Cash.

Unless the circumstances preclude such an arrangement, it is always advisable for directors to stipulate that the purchase price for goodwill, and indeed for as many of the other assets as possible, shall be taken in a form other than cash. If a complete purchase and liquidation of the vendor company is contemplated then shares in the parent company should be offered to the liquidator. If a liquidation is not to take place, but the subsidiary is to continue, then the vendors should be left with shares in the subsidiary itself to the amount of the intangible assets. This latter arrangement will not, of course, give the parent company complete control and may be a less preferable course than the first alternative. The willingness of vendors to take their consideration in a form other than cash is usually regarded by the public, when the matter is laid before them in a prospectus, as a measure of the vendors' confidence in the prospects attaching to the business they have sold. The taking of the purchase price wholly in cash may usually be taken to indicate less confidence in the property sold than the acceptance of shares. The public cannot be expected to display greater confidence in the assets than that exhibited by vendors who desire to part company with them once and for all.

The Ascertainment of Liabilities.

The ascertainment of liabilities is equally important in the case in which the vendor company pays off the creditors as when the transferee assumes the obligation. If the purchasing company assumes the liabilities then the assets price must be reduced by the amount of the obligations to be taken over. The method of taking over liabilities is perhaps the more convenient, for the process is a gradual one and less likely to interfere with trading procedure. Under the alternative method whereby the vendor pays his own creditors great care has to be exercised by the purchaser to see that invoices received after the date fixed for purchase do not relate to stock included in the purchase price of that asset. This entails considerable detailed stock-keeping and accounting work until the absorption is complete.

In a purchase from a partnership or sole trader provision should be made for the guaranteeing the purchasers against undisclosed liabilities, if creditors are taken over. In the case of purchase from a company, arrangements should be made with the liquidator in order that he may hold up distribution of funds in his hands until contingencies are remote. These precautions are of course unnecessary, from the purchaser's standpoint if the liabilities remain with the vendors.

The Future of the Purchased Business.

The valuation of the assets, including goodwill, and the ascertainment of liabilities will provide the directors with the information necessary to decide upon a price, but the question of the future of the purchased business will be the factor governing the execution or the rejection of the contract of sale. The points previously dealt with, such as retention of

goodwill dependent upon personality of officers, must be fully weighed. Agreements for service with such officers should be arranged simultaneously with the main contract.

It may happen that the type of product of either the purchased company or the parent company is of a higher grade though otherwise similar to that made by the other company. The amalgamation of two such companies has been known to have most serious effects on the trade of the company which had the better class connection before the purchase. This was due to an unfounded fear on the part of the wholesale and retail houses that the inferior goods would be foisted upon them by the controlling company.

It is not possible to formulate exact rules upon this particular portion of the work of valuation. Needless to say, it is a matter in which the ordinary business acumen of directors is called into play. They alone know the general state of trade in their particular business and—more important still—they only are aware of the prospects awaiting such ventures as the absorption of subsidiaries or extension of the parent company's field. This aspect of the purchase of new businesses may rightly be termed the most important and most onerous of the entire negotiations.

CHAPTER XII

DIRECTORS AND TAXATION

THE provisions of the various enactments relating to the taxation of companies are too numerous and complicated for directors to acquire more than a general knowledge of principles.

Some directors who have had professional careers may possibly be well versed in these matters. Generally speaking, the actual settlement of taxation affairs is left in the hands of the company's professional advisers unless the secretary or accountant has made a special study of the matter, in which case he may be authorized to deal with it. It is essential, nevertheless, that the director should have a sound general knowledge of the main principles of taxation, because his decisions upon many of the financial problems which come before the board will have a material effect upon the taxation liability of the company.

This fact was emphasized in Chapter VII, in connection with the financing of subsidiaries. It was there shown that lack of knowledge of the general principles of taxation may lead the company into making inter-company financial arrangements which may increase the income tax assessment of the group. Moreover, there are special circumstances under which a company may be entitled to reliefs or reductions in the amount of income tax normally payable, and it is very desirable that directors should be aware of these circumstances in order that when such occasions arise they may ensure that the appropriate relief is not overlooked.

The remarks which follow are intended to give the

director that general knowledge which will enable him to take a certain amount of interest in this aspect of company finance.

The Normal Basis of Assessment.

The normal basis of assessing the trading results of a company for income tax is that known as the "three years' average." That is to say, normally a company does not pay income tax on the actual profits of the year, but on the annual average profits of the three preceding years. For example, the Government's income tax year runs from the 6th April in one year to the 5th April in the following year (both inclusive). Assuming a company prepared its accounts for the year ended 5th April, 1923, and these revealed a trading profit of £50,000, the company would not normally pay income tax for the year ended 5th April, 1923, on the sum of £50,000. Its taxable profit for that year would be calculated by taking the average yearly profit of the three years to April, 1922, which might reveal a very different figure from the sum of £50,000. In practice few companies adopt an accounting period corresponding to the Government financial year from April to April, but to meet this difficulty the Inland Revenue is authorized by the Income Tax Act, 1918, to accept the annual period for which the company's accounts are usually made up as representing the trading results of that company for the year ending the 5th April next after the date to which its accounts are made up. For example, assuming a company made up its accounts to 31st December in each year, the trading results shown by the accounts for the year ended 31st December, 1922, would be taken to represent the trading results of the company for the year ended 5th April, 1923.

The following two examples will emphasize these points—

"A" COMPANY

Trading profit for year ended—

	£
31st December, 1920 . .	24,000
,, ,, 1921 . .	33,000
,, ,, 1922 . .	42,000
	3)99,000
Average annual profit . . .	£33,000

"A" Company would be assessed to income tax for the fiscal year ended 5th April, 1924, on the basis of £33,000, this being the average annual profit for the three years preceding the year ended on that date.

"B" COMPANY

Trading profit for year ended—

	£
30th September, 1920 . .	60,000
,, ,, 1921 . .	54,000
,, ,, 1922 . .	30,000
	3)144,000
Average annual profit . .	£48,000

Similarly, "B" would be assessed for the year ended 5th April, 1924, on the basis of £48,000.

It will be observed from these examples that those companies in which the profits gradually increase each year gain an advantage under the average system, because their income tax assessment each year is based on the smaller profits of the three preceding years. It seldom happens, however, that a company's prosperity shows a continuous upward trend. Usually one year or another will reveal a decline in profits. It should therefore be borne in mind by the directors that if a period of low profits follows a period of high profits

the company may be required to pay tax on a heavy assessment for a year in which actually the profits are small, and the company's cash resources limited. Under these circumstances it is desirable that in times of prosperity a company should provide a reserve against the possibility of an adverse effect of the average system whenever a period of prosperity is followed immediately by times of serious depression.

Recoupment of Tax.

A company which declares dividends is entitled to deduct income tax from such dividends and may thus recoup part or all of its income tax assessment.

Statutory Profits.

The amount of profit shown by the company's certified accounts does not necessarily represent the statutory profit of the company for that period as viewed from a taxation standpoint If, in arriving at its profits, the company has provided reserves for equalization of dividends or other purposes or has written off ascertained capital losses out of profits, or if the depreciation provided on plant and machinery exceeds the usual wear and tear allowance, then the profit shown by the accounts will be increased for income tax purposes by these non-allowable items. The statutory profits for income tax purposes may consequently be much greater than the profits shown by the annual accounts.

Modification of the Three Years' Average.

The following classes of trading concerns are not assessed on the basis of the three years' average system—

MINES (COAL, LEAD, COPPER, IRON, etc.). These

are usually assessed either on the basis of the average profit of the *five* preceding years or on the profits of the preceding year.

Iron Works, Quarries, Alum Mines, Railways, Canals, Water Works, Gas Works, Bridges, Tolls, Fishings, Docks. These are usually assessed on the basis of the profits earned during the preceding year.

Companies the Income of which is Chiefly from Taxed Sources, such as rents from properties or dividends from investments. Such companies are assessed on the amount of their gross income, but an allowance for management expenses will be granted if claimed. The Inland Revenue has the right to insist on the assessment being computed in any year on the average profits, if this gives a greater figure than the income less expenses basis.

Circumstances under which Relief may be Claimed.

There are certain circumstances under which a company may claim relief from the normal basis of assessment, and as these reliefs often represent substantial benefits to the applicants, it is important that the circumstances and the time limit for application should not be overlooked. It may be observed in the first place that while the company is entitled to claim the relief, the Inland Revenue has no power to claim a similar relief should the computation prepared on such a basis represent an advantage from their standpoint.

The circumstances under which relief from the normal bases may be claimed are—

(1) The New Business Relief. A new company has the right to claim to be assessed on its actual profits instead of its average profits in any or all of the following years—

(*a*) The first year (i.e. Government year) in which the company commenced business.

(*b*) Any of the three succeeding fiscal years.

It will thus be seen that the relief extends to the first four fiscal years of the company. If the company commences business during a fiscal year the relief will operate for the part of the first fiscal year and for the three succeeding years.

If in either of these four years the average basis of assessment is more advantageous to the company than the actual basis the latter basis need not be claimed for that year.

It must be observed, however, that a company which merely represents the continuance of a previously existing firm, but under joint stock regulation, is not for the purpose of this relief considered to be a new business although the relief outlined in par. (4) may sometimes be obtained in such circumstances.

(2) THE DISCONTINUING BUSINESS RELIEF. When a company entirely ceases business (whether through liquidation or otherwise) and does not transfer its goodwill to another concern, the assessment of the last fiscal year is amended to that of the actual profits of the year instead of the average. A repayment may also be claimed in respect of income tax paid in the three years preceding the last year to the extent of the excess tax paid over that chargeable on actual profits, as distinct from the average.

If losses had been incurred in any of these three years they must be treated as neither profits nor losses for the purpose of this relief.

(3) THE TRADING LOSS RELIEF. If a company makes a trading loss in any year it has the right to claim a repayment of any tax paid for that year to the extent of tax on the amount of the loss. A company could of course continue on the normal basis and bring

the loss into average, and in many cases the same result will be obtained in the course of three years as if repayment had been claimed, owing to the fact that in the latter case any loss so recovered cannot be brought into future averages. With a falling rate of tax, however, it will usually be found advantageous to adopt the repayment method quite apart from the added advantage—often a very important one—of obtaining an immediate cash repayment instead of a reduced assessment during the three succeeding years.

Under certain circumstances, however, the claiming of a repayment may act to the disadvantage of the company, and it is important that expert advice should be obtained before such a claim is put forward.

(4) The Specific Cause Relief. If a change in ownership occurs in any year of assessment and the company thereby suffers a diminution in profits, a claim can be made for the assessment to be reduced to the actual profits of the year. A similar claim can be made in each or all of the three succeeding years, if to do so would be advantageous to the company. As a company is itself a separate legal *persona* the only circumstance under which such a claim could arise would be when a privately owned business is converted to a limited company.

Time Limits for Claiming Reliefs.

Except in the case of the "discontinuing business relief" the time limit for lodging notice of claim is within twelve calendar months after the end of the fiscal year in respect of which the claim is made.

In the case of a discontinuance of business the relief must be claimed within three years of the last fiscal year concerned. These time limits are strictly adhered to, and care must be taken to give notice accordingly.

Supervision of Inter-Subsidiary Trading from Taxation Standpoint.

Considerable attention was given to this matter in a previous chapter under the heading of "Financing Subsidiaries," and there is no necessity to take up further space in explaining it, except to emphasize the importance of giving proper consideration to the taxation aspect of the matter before definitely committing a subsidiary to a particular method of financing. The various reliefs outlined above must not be lost sight of in this connection.

CHAPTER XIII

WORKS RATING ASSESSMENTS

The burden of local taxation is still a heavy one, and it is therefore important that a company which occupies a factory should take full advantage of every right to claim a reduction in its rating assessment. It is somewhat remarkable that the circumstances under which a works rating assessment can be reduced are not generally known and appreciated, and that often the right to claim a reduction is overlooked. It is the duty of the directors to enquire into this question from time to time so as to ensure that the possibility of reducing the amount payable in rates is constantly kept in view by one or other of the responsible officials of the company.

There are two main points connected with rating assessments with which the director of a manufacturing company should be acquainted—

(1) The circumstances under which a rating assessment, reasonable at one period, may subsequently become excessive.

(2) The general principles upon which assessments are calculated.

The Owner-Occupier and the Lessee.

The net assessment or rateable value of a property should represent the rent at which the premises might reasonably be expected to let from year to year (the tenant paying the usual tenant's rates and taxes), after deducting from such rent the probable average annual cost of repairs, insurance, and maintenance payable by the landlord. It will be seen, therefore,

that where property is let on a yearly tenancy, the tenant company bearing rates and taxes and the landlord bearing repairs and insurance, the rateable value should correspond to the yearly rent after deducting the landlord's burdens. The basis is different, however, whenever the property is occupied by a company owning the premises, and there is no comparable property from which to calculate the anticipated rent ; similarly in the case of properties let on a long lease at a fixed rent, where the value from the point of view of prospective tenants varies after the signing of the lease. In these cases the procedure is to estimate from time to time the amount of rent which a hypothetical tenant would give for the premises. Every possible tenant must be taken into account, including the actual owner-occupiers or lessees. It is in the calculation of these estimates that most excessive assessments arise, and every company occupying property which is not comparable with other property should be particularly careful to consider whether circumstances have not changed since its assessment was fixed, to such an extent as to render it excessive.

A Reasonable Assessment May Subsequently Become Excessive.

The circumstances under which a rating assessment which at one time was reasonable may subsequently become excessive can be tabulated as follows—

(1) Where the property was originally assessed on the basis of constructional cost, and the cost of replacement has fallen since the original erection.

(2) Where part of the property has been destroyed by a sudden cause such as fire, explosion or flood, or by a natural cause such as wear and tear, and it is not proposed to re-build.

(3) Where part of the property formerly occupied

as a factory is now occupied solely as a store or warehouse or is unoccupied.

(4) Where the property is suitable only for a particular trade or trades, and those trades can be carried on only at a loss, or at a profit insufficient to yield a reasonable return on the capital employed.

(5) Where property which originally had certain special licences, rights or advantages of position ceases to hold these licences, rights or advantages.

How to Appeal.

Every director and every factory executive should consider these clauses, and then closely review the works assessments. If any one or more of these conditions exist, then notice of appeal should be given at once. The procedure is simple. Application for the necessary forms must be made to the Clerk to the Assessment Committee or the Overseers of the Parish. If the address of the clerk is not known it is sufficient to apply to the Rates Collector. The forms are not intricate in any way, and only one hint is necessary: in the space marked "Grounds for Appeal" should be inserted a broad general reason instead of one precise detailed reason. Precision in stating grounds for appeal may preclude relief under one or more conditions which have been omitted, but which might have been covered by one broad reason. Forms of appeal are made out in duplicate, one copy for the Clerk to the Assessment Committee and one for the Overseers.

It is sometimes thought that appeals against assessments within the Metropolis can be made only when the assessment is originally fixed or when the quinquennial valuation is made. This is not so. Both within and without the Metropolis, if the value of the property has become reduced as set out above since

the assessment was last fixed, then an appeal may be entered at any time.

General Principles upon which Assessments are Calculated.

In order to understand the general principles upon which works assessments are calculated it is necessary to classify property under three headings—

(*a*) Properties let on a yearly tenancy.

(*b*) Properties let on long lease at a fixed rent.

(*c*) Properties occupied by owners.

As already indicated, the basis of assessment for properties let on a yearly tenancy is a simple one, and the rateable value consists of the actual rent paid less the landlord's burdens. If an excessive assessment has been made on such property, the amount of the excess is readily ascertainable, and the appeal procedure will usually be one of routine only.

If the property is let on long lease at a fixed rent it is necessary to consider whether the value of the property from the point of view of a prospective tenant has varied since the execution of the lease. If the value has not varied then the rateable value will correspond to the actual rent less the landlord's burdens, as in the case of property let on yearly tenancy. If the value has varied since the signing of the lease the basis of assessment will be calculated in a similar manner to that for property occupied by owners. Before proceeding to deal with the latter class of property it should be stated that an assessment committee will not necessarily assess a property from the basis of the rent, if the actual rent appears to be an artificial charge. In any such case the committee will proceed to calculate a hypothetical rent as in the case of property occupied by owners.

In assessing property occupied by owners it must

be ascertained whether there is any comparable property let on a yearly tenancy. If such property exists then the basis of assessment will be the rent obtaining in the case of that property less the landlord's burdens. If there is no comparable property then a hypothetical rent must be calculated.

Hypothetical Rents.

If the building is generally suitable for any ordinary trade or manufacture then the net assessment or rateable value may be expected to approximate to 4 per cent on land, 5 per cent on the present constructional cost of the premises, and a slightly higher percentage on the value of the fixed machinery forming part of the construction and passing with it. If the building is not generally suitable for any ordinary trade then it must be decided—

(1) Whether the building is constructed for certain particular trades or manufacture only; or,

(2) Whether it has special licences, rights or peculiarities of position which will enable the occupier to make an abnormal profit.

In estimating the hypothetical rent in these cases, consideration must be given to the amount of capital return or profit which a tenant occupying those premises would expect to make, this being the factor which influences prospective tenants in renting that particular building. The rateable value should not exceed the amount of profit which an ordinary tenant might expect to make, after deducting from such profit a reasonable return on the working capital employed by him in the business.

Illustrative Cases.

In order to illustrate the effect of these bases and in order to indicate the circumstances under which appeals should be lodged, the following examples are given—

(*a*) A factory is devoted to the manufacture of a commodity commonly made in the district. *The factory is suitable for any ordinary trade*, but it has a peculiarity of construction which renders it incomparable with other properties. It is occupied by the owners or by lessees with a long lease. It has no special licences, rights or peculiarities which render abnormal profits possible.

In this case a basis of 4 per cent to 6 per cent on *present* cost of the land, premises and fixed plant as previously indicated will usually be adopted. The occupiers of such property should lose no time in ascertaining the cost of replacing the factory at current building rates. This is particularly important if extravagance was indulged in at the time of the original erection or if the factory was built at the instance of Government departments at high war cost.

(*b*) A factory devoted to a manufacture *entailing a peculiar layout and construction*, e.g. special furnaces, kilns, gasometers or unusual shaped shops, is situated in a parish in which there is no similar property. It is occupied by the owners or by lessees with a long lease.

The rules applying to such a case are—

(1) If the factory could possibly be used for any ordinary trade, then normally 4 per cent to 6 per cent on present cost will be the basis. If the cost of replacing the construction falls then an appeal should be made for adjustment.

(2) If the peculiar construction of the factory precludes its use for *any other business* then evidence of profits most support any objection to the valuation. It may happen that the valuation was made at a time when the profits were consistently abnormal. With a return to normal trading times it may be found impossible to make any profit. Whether consistent losses or inadequate profits can be attributed to the

situation of the factory or to general depression in that trade is a matter of fact, and that is why the basis is said to take into account the profit which any ordinary tenant might expect to make: in other words consistent losses may sometimes be ascribed to indolence, ineptitude or to carelessness on the part of the factory occupier, but unless definite evidence of this can be produced, the actual profit or loss made is *prima facie* evidence of normal trading results.

Assuming, however, that even a normal manufacturing company failed to make a profit equal to the amount upon which its assessment is based, after deducting interest on working capital, its evidence before the assessment committee for a reduction of its assessment will be substantiated by the production of the balance sheet and profit and loss account. The explanation may possibly be found in the item "Carriage and Cartage." The company will give evidence that the distance from the railway sidings to the factory is such that it eats into the margin of profit and places it at a disadvantage as compared with its more fortunately situated competitors in other districts. Again, its site may be liable to flood and its stock exposed to damage by water. The factory may be situated at a long distance from the source of supplies of raw material. Labour may be scarce in the district or the rates of pay in the parish may be above the normal for that particular trade.

Supported by such evidence the company should be able to obtain a reduced assessment varying according to circumstances from something below the normal rateable value based on constructional cost down to that which would be applied if the factory were but a warehouse.

(*c*) A factory, similar to the one considered in example (*a*), is occupied by the owners or by a lessee with a

long lease, but in this case the peculiarity of construction *permits the making of abnormal profits.*

In this case the basis will take into consideration the surplus profit which an ordinary tenant (including the present occupiers) might be expected to make in a building not possessing the particular advantage, plus the additional profit due to the peculiarity of construction. This economic "surplus" will only be taken into account if any ordinary tenant could make it, and it is necessary to differentiate between abnormal profit attributable to the advantages of the factory and the abnormal profit attributable to the special ability of the occupiers. The former is taken into account, but the latter is not.

These three examples cover the three main classes of property occupied by factory owners or by lessees of factories on long lease. The director should apply them to his own case, and take steps to ensure that a reduction is obtained if his company's property is over-assessed. In every case a periodical review should be made, preferably on each occasion the notice of the settlement of a rateable valuation list for the parish is posted on the church doors.

Whenever any change occurs in the construction of a factory or in the uses to which it can be put, or whenever a general depression occurs in a particular industry the director should ask himself whether the change affects his company's assessment. Similarly if a fire or explosion occurs, or if from any other cause part of the factory is thrown into disuse, or if a furnace or shop is closed down or otherwise thrown out of commission, or if an appreciable fall occurs in the cost of factory construction, then steps should be taken to procure a reduction of the rating assessment and such an application will rarely prove abortive.

PART III

The Director and Control of Production

CHAPTER XIV

ECONOMIC PRODUCTION

It is often said with some truth that the success or failure of a company can depend upon the control of its production to a greater extent than upon any other factor. Certain it is that the companies fortunate enough to receive a continuous and steady flow of orders are rare; the remainder are necessarily faced, periodically, with a problem which is no less critical than that involved in the control of cash. Periods during which the factories of the company suffer from lack of orders may be covered in two ways—the closing of the factories or at least certain of the shops, and the continuation of the factories on stock orders. The execution of the policy to be followed may usually be left in the hands of the managing director, subject to the sanction of the board before either alternative is adopted. The decision to continue on stock production or to close a works is one of importance and should invariably be supervised by the directors.

Comparison of Cost.

Whenever it is found necessary to turn to stock production for any length of time the directors will be provided with an estimate of the stock to be produced, its value and the cost of its production. They will also receive a statement of the expense which will be entailed in closing the factory, and in re-opening at a later date. The latter is extremely important, for

in certain businesses it happens that loss on stock production will be less than the cost of re-lighting furnaces and the cost of maintenance during the silent period.

Class of Stock Produced.

If it is decided that the factory shall be employed on stock production then a schedule of the class of goods to be produced will usually be prepared by the sales manager in consultation with the works executive or the managing director. These schedules from the sales manager and the works manager must be examined by the board. It is always unwise to allow the sales manager to dictate a production programme to a works manager or to allow a works manager to produce according to his own inclination. The sales manager usually knows little or nothing about the methods of production, the shortcomings of work-people, or the peculiarities of plant; and his programme will naturally be to produce the goods most easily saleable. The works manager will quite naturally, on the other hand, choose a programme of goods most easily produced.

The board must consider the scheme of production from every aspect and particularly from the point of view of capital available. They alone have the wider knowledge on such matters as capital-control which enter into these problems to a far greater extent than those affecting the departmental managers. The directors will not only take into account the cost of production of the stock and the possibilities of its adaption to fill orders when they arrive, but they must consider the cost of financing this asset over a period. The cost may include warehousing, insurance, handling, re-packing, and charges for interest on bank loans. The capital control statement will furnish a great

deal of the information required, particularly showing the influx of cash which may be expected and the amount required to meet the wages and materials charges.

Only after an exhaustive examination of the cash position and an enquiry into the effect upon this at the end of one, two, or three months, should a decision be recorded adopting one or other alternative. If it is decided to proceed with stock production, then the decision should be recorded and the matter allowed to take its course. Although it is advisable for the directors to approve the schedules governing the production for stock, they should not endeavour to dictate details of procedure to either the sales manager or the works executives. The sales manager may be relied upon to improve the position by turning stock into debtors, and the works manager should be left to produce the goods as efficiently and economically as he can. The rule of non-interference does not preclude the tendering of advice which will usually be accepted and followed. Unfortunately, however, there is a tendency to interfere with works management, especially in times of stress when it is necessary to produce goods for stock to keep the works going.

Shortage of Orders.

The occasional necessity of making for stock on account of temporary shortage of orders will usually be overcome without causing the time of the board to be occupied considerably in discussions of policy. All concerns naturally pass through these periods and emerge from them quite successfully with a small stock produced after consultation between the sales manager and works manager, the stock usually finding a ready market soon after the temporary lull has passed. There are many advantages in filling in gaps between

sufficient volume of orders, with stock production. In the first place it is necessary to retain the confidence of skilled employees in the permanency of their work. False economy often leads to the dismissal of experienced workmen during temporary slack periods, their replacement at a later and busier period proving no slight obstacle to the company's welfare. Again, the production of stock leads to speed in the execution of customers' orders as soon as they arrive. In this way goodwill is fostered and a reputation for efficiency is engendered. Lastly, the maintenance of production at its maximum preserves the allocation of standing charges over each unit. To refrain from making the fullest output on account of shortage of orders causes the spreading of the overhead charges over a smaller number of units and may lead to production of the goods for order at a cost higher than the price obtained for them.

Production in Economic Quantities.

It is an established principle of scientific management that it is cheaper to produce a large quantity of one article at one time than to manufacture several smaller quantities at different times. It will often pay to make a larger quantity of goods than is required for the fulfilment of immediate orders, and to place the balance in stock. This principle, which is due to the increased accuracy and efficiency attained by the worker during a long spell at one class of article, should be borne in mind when considering production programmes.

Danger of Over-Production.

Production of stock lines indiscriminately must be rigidly disallowed. The sales manager is always in a position to provide tables showing the average monthly

sales of standard articles in quantities and the average amounts and quantities held in stock. It is then possible to fix a maximum and minimum stock from this information and to direct that the limits should be adhered to. The stock-keeper will inform the works manager whenever a stock line has been depleted below the minimum and the manager will then take steps to include that line in his next programme of output. The details of such a method as this will not usually concern the director but it is advisable that he should be acquainted with the procedure followed in his own company. Generally speaking, the minimum stock of a standard line should represent the average demands of the customers over a period corresponding to the period of manufacture of that article.

The Director and Production.

It will be observed from the foregoing that the director can only maintain a controlling hand over the production of his company. Once he has sanctioned any scheme he can only allow the departmental managers to carry out their own duties. There is, however, nothing to prevent him from following the effect of production programmes upon the financial statements and reports presented to him, and this should always be done. The decision of the director upon production is nevertheless the deciding factor, and nothing should be done to lessen the control which lies in his hands over excessive production, economic production, or closing the factory, should the latter policy be dictated by the information afforded him from time to time. In the first place, he must guard against sanctioning the locking up of working capital in stock under such circumstances that difficulty will be experienced in meeting running charges and the demands of creditors. He must give full consideration

to the representations of the sales manager as to seasonal demands or seasonal periods of slack trade. The effect upon the stock of excessive handling and storing must be weighed, and last but not least, the estimates of costs under alternative programmes must be carefully understood.

CHAPTER XV

THE COSTS OF PRODUCTION

Costs of production are prepared by means of a costing system or method of accounting ancillary to and explaining the main results of the company's bookkeeping. Whereas the accounting system provides the directors and other executives with information concerning the loss or profit of the whole concern over a period, a costing system reveals the cost of production per unit or department. It is not necessary for the director to delve into the details of costing but he will be well advised to grasp the principles underlying the matter in order that the knowledge may assist him in the consideration of production control.

The aim of a costing system is to ascertain the cost of production of each unit of the company's manufacture. The term "unit" is used to indicate that measure of output or service upon which a cost may most easily be placed. Thus a "ton of coal" may be the unit for a colliery company, a "department" may be the unit of a multiple or retail stores, "a train mile" in the case of a railway company, "a printing job" in the case of a printer, and so on. The periodical financial accounts reveal the total cost of the whole of the company's manufacture over a period, the losses sustained in the manufacture and disposal of one type of article being masked by the profit arising from the manufacture and sale of others. The aim of costing is to analyse the items of expenditure, split up the manufacture into units, and to allocate the cost to each unit concerned. In this way it is ascertained whether any of the company's products are manufactured at a loss or at uneconomical profit, such

sources of drain upon the company's capital then being eliminated from the programme of production, or the system of manufacture overhauled with a view to turning the loss into a profit.

Costing Personnel.

The practice of costing is now fast becoming a science. No little credit for the benefit it confers upon industry is due to the admirable work of the Institute of Cost and Works Accountants. This Institute has for its aim the training and examination of costing personnel, research into scientific methods of costing, and the instilling of interest and enthusiasm in the minds of business executives who may not have fully realized the benefits to be obtained from the science.

It is not always necessary that separate staffs should be engaged for the ascertainment of costs. Indeed, it is always advisable to introduce a system with as little elaboration as possible until the needs of the business are correctly gauged. As elaboration proceeds, however, it becomes necessary for larger concerns to institute a separate costing staff under the charge of a cost accountant. The cost accountant should be given real responsibility, but as it is necessary that his records should agree with those kept by the main accounts office, it is advisable that he should be subject to the authority of the secretary. The work he performs is not only intended to provide information on costs to the sales manager and particulars of production programme costs to the board, but is also designed to assist the works manager in the economical running of his department. For this reason the costing office should be housed in the works. Under certain circumstances it is advisable that the costing office should be subject to the control of the works manager,

or that there should be close *liaison* between the cost accountant and the works manager. The reason for this co-ordination is that the cost accountant cannot produce any costs without the fullest information from the works staff on such matters as time spent on jobs, methods of working, weights of fuel used, and so on. Unless there is co-ordination, the result will be either friction or incorrect costs.

The Objects of Costing.

It is sometimes said that the financial accounts deal with the expenses of a company in terms of sterling, and that the cost accounts deal rather in weights and measures of time. Whereas the financial accounts show the value of material consumed over a period, the costs accounts are designed to account for the weight of the material used, thus revealing excessive loss, wastage or pilfering. Again, the financial accounts show the total wages paid, but the costs accounts, while accounting for the total wages paid and agreeing the amount with the financial accounts, go further and show how much time has been expended by the workers on each unit and what the cost of that time has been. Lastly the financial accounts give the total overhead or oncost charges of the whole company. The cost accounts split up or allocate the overhead charges over each unit or department. It will be seen therefore that costing is designed to show the wages, material, and overhead charges per unit or department, the loss or profit arising on each, the summarized results agreeing with the composite figure shown or to be shown in the financial accounts. The expression " to be shown " is an important one for it covers one of the principal advantages to be derived from the installation of an efficient costing system.

The financial accounts, as explained in previous

chapters, are only made up periodically. In some businesses it is possible to produce approximate profit and loss accounts each month, but in many manufacturing businesses it is impossible to compile accounts with any degree of accuracy at shorter intervals than six months. It is clear then that when accounts are prepared only half yearly it is possible for a loss to be sustained during the whole of that period without the cognizance of the directors. Costing accounts, on the other hand, are running continuously. No sooner is a job completed than its cost is known, and information is therefore available immediately concerning either a general loss or a loss on any particular contract or job.

Constituents of Cost.

The three main constituents of costs were mentioned above under the terms "wages," "material," and "oncost." In costing nomenclature it is usual to term wages and material by the single term "prime cost." Overhead or running charges, such as salaries, office expenses, selling expenses, and so on, are termed "oncost." The director is likely to meet with these terms on many occasions and he should therefore understand what they are intended to convey. It is sometimes customary to divide oncost into two classes—"works oncost" and "office oncost." Works oncost consists of that portion of the overhead charges attributable to the factory, e.g. works lighting and heating, foremen's and supervisors' salaries, and the proportion of rates, water rent, and similar outgoings chargeable to the factory, based upon floor space, meter readings, or such like methods of allocation. The other terms with which the director is likely to meet are those which indicate the method of costing in use. "Terminal costing" is that applied to such

businesses as contractors' concerns, in which each contract is definable. It is possible to charge each particular contract with the exact wages and materials consumed, and after allocating oncost and crediting the contract price, the exact profit or loss is known. "Single costing" is adopted in companies producing but one standard article. The cost per single unit is obtainable by dividing the output into the total cost. "Multiple costing" is applied to businesses engaged in the manufacture of more than one type of article. It is designed to reveal whether each class of product is produced at a loss or a profit, indicating whether the prices charged are too low or too high. "Departmental costing" is adopted by such concerns as retail shops engaged in more than one class of trade. The cost, and therefore the profit or loss, of each department is given. "Operating costs" are used by undertakings engaged in the provision of services, e.g. lighting companies, railways, tramway companies and gas companies and the cost per train mile, per therm, or per traffic mile is thereby derived.

The Benefits of Costing.

The benefits to be derived from the installation of costing may be summarized as follows—

Cost accounts—

(1) Indicate whether the selling price of a particular commodity or unit of service results in a profit or loss.

(2) Indicate the price which must be charged for a commodity to show a profit.

(3) Reveal any substantial variation in cost of production within the shortest possible time, enabling steps to be taken to curtail heavy loss or to take advantage of increased trade.

(4) Provide information as to the effect on cost of any variation in output.

(5) Indicate the economic output which must be maintained to produce the maximum profit.

(6) Enable concentration to be exerted by the sales department in pushing the disposal of profitable lines, and eliminating the sale of unprofitable items whenever the cost of the latter cannot be reduced to an economic figure.

(7) Provide information concerning the separate running cost of different types of machines, comparison of the cost of different workmanship, and the varying cost of such items of plant as furnaces, kilns, etc.

(8) Furnish data upon which quotations may be based.

(9) Reveal loss of time, wastage of material, defalcations of cash and similar loss of the company's assets. They account for, and confirm the expenditure in weight and value of every charge appearing in the financial accounts.

(10) Point out the occasions upon which it is more profitable to let out work on sub-contract or to take into the factory any work previously placed with sub-contractors.

It will be realized from the foregoing that there is no better aid to the director in any efforts he makes towards economy in his company or efficiency in its production than costing. By its aid he is enabled to review separately the three classes of expenditure charged in his company's accounts, at the same time studying the effect of projected economy upon production as well as expense. The items over which the director should exercise control are—

(*a*) Raw materials.

(*b*) Wages.

(*c*) Oncost generally.

With regard to raw materials, it is advisable that the execution of contracts for supply of fuel, oil, steel,

and any chemicals subject to convention should be carried out by the board. Power to make such contracts is occasionally granted to subordinate officials by power of attorney, but there is every reason why contracts which commit the expenditure of considerable portions of the working capital, and which contain clauses mulcting the company in damages in the event of agreed amounts not being taken up, should invariably be laid before the directors for sanction. The proposed contracts will be supported by a memorandum from the buyer and only in exceptional cases should his advice be disregarded. Exceptional cases would arise whenever the capital-control statement indicates that the laying-in of extra stocks cannot be financed without difficulty. The company will benefit from the moral effect caused by an instruction that all forward commitments relating to raw materials and fuel shall be approved by the directors before execution. The control of stocks will depend upon the efficiency of the works manager and upon the system of stores recording, the latter duty falling within the province of the cost accountant. Although it is advisable for the director to interest himself in the material purchases of his company as much as possible, he should never over-ride the recommendations of the buyer to the extent of ordering the purchasing of different brands of goods. The practice of influencing the purchasing of raw materials from other companies in which a director happens to be interested causes no little dissatisfaction among works executives. They should be credited with knowing the particular class of raw material best suited to their work, and it stands to reason that any materials foisted upon them for the private benefit of a director will seldom be judged suitable by them. In certain cases it may be desirable for the works to purchase their

supplies from particular companies, especially so when the supplying company happens to be a subsidiary company. There are ways by which the works executives may be induced to order those goods in preference to others without the necessity of giving direct orders to that effect.

Wages.

The control of the board over wages should be general, but at the same time sufficiently wide to enable them to deal with matters of policy connected with the worker, labour disputes, increases of rates, and betterment of conditions connected with wages. It is impossible to understand questions affecting wages without spending some time in consultation with the works manager, and for this purpose the directors should arrange for frequent conferences between the board and those who directly control the worker and fix his pay. Wages, of course, are subject to many factors other than the whims and dictates of directors, and it is not suggested that conferences of the nature referred to should be held for the purpose of fixing rates of pay. They should be held for the purpose of enabling the director to gain a correct idea of the conditions prevailing in the factory, of the wages earned, and of the hours worked. He will then be in a position to take part in the settlement of disputes which may arise from time to time. Too often do directors ignore this matter beyond asking the secretary the average rates paid, or the highest rates paid, or the number of hands employed, or confining their attention to the item of wages expressed only in sterling figures in the costing or production reports laid before them. These spasmodic requests for information should never permit a director to imagine that he is controlling this item of his company's expenditure.

Oncost.

The company's oncost will be brought before the directors in many forms, but usually in an oncost sheet prepared by the costing department. This class of expenditure is more readily grasped by the director than the other constituents; it is fairly constant from month to month, and fluctuations can readily be explained by the secretary or cost accountant in whose department the expense is summarized. The oncost sheet sets out the salaries paid, the charges for rates, water, lighting, cleaning, office expenses, stationery, travelling expenses and advertising. The director should compare the sheets from month to month and satisfy himself that the effect of oncost fluctuations have been fully realized in the consideration of all production programmes.

There is one other matter into which the director should enquire on each occasion upon which he reviews the revenue expenditure outlined above, and that is the outlay of the company in capital expenditure. The question arises on many occasions, but particularly whenever changes in methods of production are under consideration. Slight changes in production programmes are often sufficient to call for capital outlay. A rule should always exist that capital expenditure must be authorized by the board. Capital expenditure does not necessarily imply the purchase of new plant or the erection of new buildings by outside builders and contractors. It covers also the employment of the company's workmen and the use of the company's material in the building of new machinery, the installation of new furnaces, the erection of additional producers, or the laying of new mains. Any proposition to divert revenue expenditure to capital purposes should be brought before the directors immediately and their sanction should be

obtained before the work is commenced. It is advisable to extend this rule to the employment of the company's workmen, materials or technical staff in experimental work. Although it is undesirable to curtail experimental work considered necessary by the company's experts, its pursuit should receive the authority of the board in every case, after consideration of the financial aspect.

A form of oncost sheet in which a company's overhead charges may be summarized, is here inset.

CHAPTER XVI

THE DIRECTOR AND SALES ORGANIZATION

In the brief reference to sales organization in Chapter II, it was explained that this side of a company's activity is committed to a separate department under the charge of a sales manager. This division is one of the three main groups into which the whole administration is split up, the other two being production management and financial management. The officer in charge of the financial management is not regarded as the sole financial manager, for the real control of his department is necessarily subject to the detailed consideration of the board. Similarly with the head of the production department. In the case of sales management, however, the manager is rather more independent of control and it is therefore necessary for the director to ensure that what control he has is rendered effective. The sales manager should be a man of specialized experience and it is desirable that he should also possess an all-round knowledge of the administration and organization of joint stock companies and the principles underlying their finance. The latter qualification will enable him to preserve a *liaison* with the finance management, without which successful salesmanship is practically impossible.

Relative Importance of the Sales Manager.

The importance of the sales manager usually varies with the nature of the sales policy which his company is able to adopt. The adoption of a policy is not always a matter of choice, for the determination of

selling prices—which is the chief factor in the policy—depends upon whether the company is able to follow costs and estimates, whether it can impose monopoly prices, or whether it must follow trade practice. These three divisions represent the main methods upon which selling prices may be based. The importance of the sales manager will be relatively less when his company's prices depend upon the work of a production estimating-department than when he is left to follow trade practice and by his own initiative prove himself a sales manager in actual fact.

The Director and the Sales Manager.

It must be remembered that except when the sales department disposes of the company's products upon terms dictated by other departments, e.g. by commercial estimators or a costing department, the profit or loss on the company's accounts may depend entirely upon the efficiency of the sales manager. An inefficient sales manager who is allowed to fix selling prices without supervision may easily dispose of the whole of the margin between cost and a fair selling price. In his anxiety to force up his sales he may cast aside the co-operation of other departments and with impunity forgo any production profit which may have been made. It is, however, quite possible for the director to control the sales without trespassing upon the sales department's province, and the following methods should be considered.

Production Profit.

In Chapter V an illustration of a manufacturing account was given. That account was based upon a business in which selling prices were fixed by trade practice. It was therefore possible to transfer the

production to trading account at market or wholesale prices, the balance on the account representing the production profit made by the works. Now if the director regards the transfer to the trading account as equivalent to a sale of the works production to the sales manager at wholesale prices he will appreciate that he easily gauges the efficiency of that official. The production profit in that example amounted to £19,675, thus indicating that the efficiency of the production management resulted in the manufacture of the goods at a cost £19,675 less than would have to be paid for the products in the wholesale market. The gross profit shown in the trading account, amounting to £40,410, represents the trading profit earned by the efforts of the sales manager. This is the first method by which a certain control may be maintained by the director over the sales department. It is not advanced that either amount of profit indicates maximum efficiency; other indications must be examined before that conclusion is adopted. It is clear, however, that whenever the first balance (on production account) shows a profit on wholesale prices, and the second balance (on the sales manager's account) shows a loss, the director must act at once. An investigation into the methods of the sales manager is imperative.

Disposal of Production.

Turning once more to the capital control statement we shall observe that the monthly increases or decreases of stock is ascertainable by comparison of the entries under this heading month by month. This point is of considerable value to the director in his control over the sales. In order to obtain a clear view of the work of the sales department over a period it is necessary to examine the return of sales, the return of

production and the capital control statement simultaneously. A decrease in the sales and an increase in the stock must be explained by the sales manager very fully. A decrease in the sales without an apparent effect upon other items will lead the director to compare the schedule of outstanding orders with the schedule prepared for the previous month. It may be found that the works manager is not preserving a *liaison* with, or co-operating efficiently with the sales manager. It is the duty of the director to investigate the matter and to pursue enquiries in both directions. The capital control statement itself may possibly show that a remarkable increase in the sales has led to a similar increase in the sundry debtors. The director, and not the sales manager, is responsible for the control of working capital, and such an occurrence as this, which may conceivably hamper the company's finance, must be attended to by the board. It is one of the cases in which the directors must preserve strict supervision over the sales department, examining the terms of credit it is allowing to customers, and deciding whether those terms can be continued.

The lines of enquiry based upon the periodical returns as set out above cannot be regarded as exhaustive. Enough has been written, however, to indicate that by making full use of the periodical returns outlined in a previous chapter the director may maintain a close watch on the sales policy of the company, however much it may be committed to one man.

Sales Statistics.

Reference was made in a previous chapter to the fact that the sales department keeps no books of account. The daily, weekly or monthly total of sales

invoiced is compiled in the accounts office and may be laid before the board by the secretary, or it may be passed on to the sales manager for incorporation in his own report. Totals of sales invoiced are not, however, always sufficiently indicative of the results of the sales department. It may happen, for instance, that very good results achieved by the sales manager in a particular month may not be seen until some time later when the goods have been manufactured or the orders imported from abroad. For this reason it is desirable that the sales manager should prepare sales statistics suitable for the particular business, and that he should submit them to the director. The compilation of the statistics will not involve much clerical labour, but it will be found that many sales managers are averse from keeping such records on the ground that their travellers are required for selling goods and not writing up records. This excuse is indeed a plausible one but it should be observed that the inclusion of sufficient data in reports to permit the compiling of a statement of sales in particular towns, or of sales of a particular commodity, or of information concerning complaints cannot possibly over-burden the traveller to the extent of causing him to neglect the primary object of his employment. In any case the traveller must make reports, and it will be found that where insufficient co-operation is maintained between the works manager and the sales department the traveller will always find time at least to set forth customers' complaints in his reports, in this way providing an excuse for his own poor results. If the director arranges for the furnishing by the sales manager of statistics based upon orders, then he will be in possession of fairly complete information regarding the sales department of his concern. It will be necessary to read together the following returns—

From the Secretary	*From the Sales Manager*
(*a*) Value of goods invoiced, daily, monthly, or as desired	(*a*) Quantities or approximate value of orders under headings of different commodities
(*b*) Value of goods returned by customers	(*b*) Report on nature of complaints leading to returns reported by the Secretary
(*c*) Classification of goods invoiced	(*c*) Values of orders from different travellers or different territories
(*d*) Amount of sales for which customers have not paid (in Control Statement)	(*d*) Quantities or values of goods ordered but not yet produced

It will be found that enquiries based upon these returns will provide the director with information concerning the last remaining point upon which he should satisfy himself. This last point is whether co-operation, to which passing reference has been made, is fully maintained.

Co-operation with the Accounts Officer.

The usual result of lack of co-operation with the accounts officer is that the sales department grants credit to all and sundry customers, no matter what their past record may have been. The natural outcome is a debit in the company's accounts for abnormal bad debts, and for this loss it usually happens that the finance officer is left to make what explanations he can. The director should see that the finance officer is consulted before large orders are accepted from customers who may eventually fail to meet their obligations. It should not be possible for travellers to take definite orders without restriction of some kind. In many companies the travellers are encouraged to obtain orders at all cost, or at least they are not restricted in the matter of the terms they grant. Wherever this occurs it will be found that additional allowances, extra discounts, and long credit are promised freely by the traveller and that on many occasions he

will fail to notify the accounts department fully or give the finance officer an opportunity of approving the concession. This lack of co-ordination inevitably leads to complaints from good customers as soon as the accounts department press for payment on the usual terms, ignorant of the magnanimous conditions granted by the traveller or his manager. This state of affairs is unfortunately of frequent occurrence. It is due, in no small measure, to the growing custom of investing the sales manager and his subordinates with an unfettered authority and regarding their work as paramount in the whole organization. That sales management is indeed a field for specialization is not denied. The improvement of the status of sales manager cannot fail to have a beneficial effect on the company. At the same time it is to be regretted that selling the company's products should be regarded as the only factor upon which the success of a concern depends. An eminent business man recently remarked that "if the process of elaboration of sales departments continues on this side of the Atlantic with the same disregard of cost as is indulged in upon the other side, the majority of concerns will be selling goods for the manufacture of which they have no means." This reference, incidentally, is equally applicable to many other departments in a company's organization.

In order to foster the co-operation which is so necessary between the accounts office and the sales department, it is essential that the sales manager should not be given supreme authority to sell goods indiscriminately. His work certainly consists in the disposal of the company's production, but it should not be possible for him to convert a tangible asset into one of more or less problematical value. Whenever the remuneration of a sales manager, traveller, or agent consists in part of a commission on sales, the

director should ensure that the commission is payable on cash received, or that the commission account is charged with bad debts and excess discounts.

Fixing Prices.

The compiling of catalogues, and the preparation of price lists will usually be carried out by the sales manager, but it is advisable that the director should supervise the latter. The case of contract companies in which prices are based on costs and quoted by the estimator need not be considered. The board will naturally have an opportunity of approving or rejecting contracts of any magnitude. In the case of monopoly commodities or goods sold at trade practice prices, however, the directors will receive two lists—one containing the suggested base selling prices, and the other setting forth the cost.

It is not possible to set out the full considerations governing the fixing of prices in either case within this volume. As a general rule it may be stated that the process of discovering the economic price giving the highest return on a monopoly (not necessarily the highest price) can be carried out with success only by following the costs. It is the duty of the sales manager to advise the board upon economic selling prices in such businesses, and the directors may arrive at their decision from that information, considered in conjunction with the costs laid before them.

It may be mentioned at this point that even where the commodity sold is a patent or is controlled by a trust the economic price will usually be a reflection of the trade-practice price obtainable for substitutes, or for the goods of competitors outside the convention. With regard to trade-practice prices, the director will be well advised to make full use of the schedule of costs. Unfortunately, he cannot be advised to insist

on a rigid cost basis for selling prices, for trade practice in almost every type of business in England continues to reveal glaring fallacies when compared with analysed cost. The selling price must continue to follow the trade until the adoption of standard rates revealed by standard trade costing becomes universal. This does not mean that the cost schedules cannot be used. On the other hand, it may be found that departure from trade practice by substituting lower prices justified by the costing can be carried out immediately. Again, the director may find that many suggested selling prices, if adopted, will result in a heavy loss to the company. In such cases it is obvious that the production of the lines concerned must be eliminated or an enquiry must be made into the method of manufacture. The use of the two schedules and the part to be played by the director is thus clearly seen. The sales manager is quite justified in following trade practice; it is the director's duty to examine the prices, and to link the sales department's policy with that demanded by the statistics of manufacture.

Co-operation with the Works.

The director should pay particular attention to the portion of the sales manager's report or statistics dealing with the complaints from customers leading to the return of goods, and with the portion setting forth the quantities of goods ordered but not produced. These sections of the report may often enable the director to arrange better co-ordination between the sales department and the factory. When proper arrangements do not exist, it may be found that allowance for goods alleged to be faulty are granted too freely by the sales officials. This procedure does not always lead to harmony in administration. As a general principle, the production executives should be given

an opportunity of inspecting the goods returned before any allowance is made and before an apology containing recriminations against the works is sent out by the sales department. In the majority of cases it may be arranged that allowances for faulty work shall be made only on the joint sanction of the works manager and the head of the sales department.

With regard to the orders outstanding, the director should ascertain whether the delay is due to an abnormal rush of orders, shortage of stock, or breakdown in the factory of any description. Satisfactory explanations will usually be forthcoming, but it may happen that the real cause lies in a failure of the sales department to realize the limitations of production. Possibly orders have been taken indiscriminately for goods of a pattern not usually produced with a general assurance to the customer that the peculiarity in type can be overcome.

There is a good deal to be said for promotion of a company's goodwill by refusing to disappoint a customer; at the same time it is not advisable for the sales department to follow the practice without keeping well in touch with the department responsible for executing their orders. By co-operation it will be found that the practice can be rendered beneficial to the company, for the production manager will be able to advise the sales manager to what extent, and in which direction, he can cope with the results of that policy. Without co-operation, it is possible for the practice to become a real hindrance to profitable production.

Another factor which frequently leads to the accumulation of orders is the practice of promising delivery of particular orders at stated dates without previous consultation with the works manager. As a general principle, it should be laid down that work commenced

and running through a factory should continue running until it reaches the finished stores. To send in production orders for execution before completion of goods in course of manufacture, and without first conferring with the works manager, naturally leads to an all round delay, increased cost, and often imperfect workmanship. The works manager will, however, often be able to promise early delivery of many orders which will not delay output in other parts of his shops. By such methods as those outlined above the director will be able to satisfy himself that coordination is maintained. The information indicating lack of co-operation may be gathered from the returns presented for his consideration.

PART IV
The Director and the Shareholders

CHAPTER XVII

DIRECTORS AND THE ANNUAL ACCOUNTS

At the close of the company's financial year the director is called upon to prepare an account of his directorship for presentation to the proprietors covering the year since he last reported to them. The actual preparation of the draft accounts will be carried out by the secretary or accountant, and they will be laid before the board for discussion, alteration and final approval, and then handed to the auditors for examination. In all probability the auditors will have carried out certain of the detail checking work in order that the presentation of the final accounts may not be delayed. In many cases also the auditors may attend at the deliberations of the directors, assisting the board in the capacity of accountants, and advising the directors upon the form of their accounts.

The Formation of Committees.

There is a widespread practice of delegating the preparation of annual accounts to small committees composed of three or four members of the board. It may happen that this practice is found advantageous in many of the instances in which it is followed. Unfortunately, however, it is not one which can be fully commended. It is naturally considered a welcome procedure by directors whose attendance at accounts meetings would in no way assist in the deliberations and would interfere with their own convenience. It has been previously pointed out in this volume that there is no excuse whatever for any director failing to make himself acquainted with the principles upon

which his accounts are prepared. The accounts sent out to the shareholders are as much his accounts as they are those of any other member of the board. No director should retain a seat on the board of a company unless he understands the information sent out to the shareholders in his name. That many directors do not realize the import of information sent out in their accounts is common knowledge. This anomaly is due in no little degree to the system of leaving the preparation of accounts to small committees.

Whenever the number of directors on a board is not unwieldy, the committee system should be abolished in respect of any meeting at which the annual accounts are under discussion. If there are too many directors to permit of sufficient progress being made in the preparation of accounts, then the committee system should only be adopted subject to the proviso that full reports and all draft documents are circulated to each non-committee member, accompanied by the recommendations of the accounts committee. These provisional documents should be thoroughly examined and sifted, and power should always be reserved to any director to attend an accounts committee should he so desire, in order that any particular suggested procedure may be made perfectly clear to him.

Procedure at Accounts Meetings.

A few days prior to the date of a board meeting at which accounts are to be considered, the secretary circulates among the members draft manufacturing accounts, trading and profit and loss account and balance sheet. The balance of profit or loss shown in the revenue account should not surprise the director, for he should be already acquainted with approximate results of the year's trading disclosed by the periodical trading or manufacturing returns handed to him during the

year. It is not unlikely, however, that the final profit or loss will differ from the aggregate of the results previously compiled, the difference being due to the decisions of the directors on the final charges for depreciation, the writing down of intangible assets or the elimination of such items as preliminary expenses from the balance sheet.

The attention of the director will be devoted to two processes connected with the profit and loss account, firstly, the inclusion of charges against profits, and secondly the allocation of the profits when the final balance has been struck. It is therefore necessary to explain the difference between charges against profits and appropriations of profit, and for that purpose the charges against profits will be dealt with first, and the explanation of appropriations will be left until the compilation of the balance sheet is considered.

The Draft Account.

In order to assist in the explanation of the items calling for the attention of the directors the example shown on the next page of a simple trading and profit and loss account will be used.

The director should keep his copy of the preceding year's accounts beside him whilst examining draft accounts similar to the above. This will not necessarily enable him to draw immediate conclusions from apparent increases or decreases of items but it will attract his attention to substantial fluctuations and lead him to obtain the explanations he may require.

In the example given there is an increase in the stock over the year of £5,778. This may be due to an increase in the volume of stock or it may be due to an alteration in the method of pricing. The stock schedules should be called for at once. It will be found that the lists have been certified by a responsible

officer who will be able to give the basis of his valuation and point out the items accounting for the increase in volume. An increase will not require so much attention as an alteration in the basis of valuation, for the capital control statement has already indicated the monthly increase in volume, and the circumstances will be known to the directors. If it appears, however, that the stock has been written up in the draft accounts presented, full explanations should be forthcoming. The basis adopted should be either the cost price or the market price, provided that market price is adopted only when it is lower than cost. As a guide

MANUFACTURING AND PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 31ST DECEMBER

		£		£
To Stock, 1st January		26,200	By Sales, less returns	262,298
„ Purchases, less returns		124,814	„ Stock, 31st December	31,978
„ Manufacturing Expenses		25,314		
„ Wages		43,210		
„ Gross Profit carried down		74,738		
		£294,276		£294,276
		£		£
To Salaries		8,156	By Gross Profit brought down	74,738
„ Travellers' Salaries and Expenses		3,187	„ Discounts received	262
„ Rates and Taxes		1,981	„ Dividends received	2,500
„ Insurance		567		
„ General Expenses		1,345		
„ Discounts Allowed		3,283		
„ Interest and Bank Charges		522		
„ Directors' Fees		2,500		
„ Bad Debts Reserve		785		
„ Reserve for Discount on Debtors (2½% on £27,641 out of total amount of £48,788, the balance representing net sales)		692		
„ Debenture Interest		2,500		
„ Depreciation—				
Patents 10% on £3,000	£300			
Buildings 3% on £15,000	450			
Furnaces 25% on £6,000	1,500			
Machinery 10% on £5,000	500			
Furniture 5% on £1,000	50			
		2,800		
To Net Profit		49,182		
		£77,500		£77,500

to the attitude to adopt, the director should consider whether the stock pricing has been carried out on a basis showing a profit which may never be realized. Thus, in the above example, he may discover by his questioning that the stock has been valued at cost, but that its selling value is £27,000. This means that the gross profit of £74,738 is over-stated to the extent of £4,978. The effect on the balance sheet is that the assets side will be inflated by that amount and the liabilities side will show a larger amount available for dividend than is really the case. Unless there are good reasons for the procedure, the directors should not permit departure from a sound basis of valuation adopted in former years. In a merchanting company the stock is often valued by taking the market selling price and deducting a percentage for profit which will cancel the average profit originally added to the purchase price. If a larger percentage is deducted in any one year the effect is that the profits will show a comparative fall. The profits in the following year should be correspondingly higher, but if the effect of the change in valuation has been overlooked then the increased profits may possibly mask increased expenditure or decreased efficiency in management during that subsequent year. Attention is drawn to this matter to show the importance of ensuring that the basis upon which the accounts are prepared remains constant. Unless this is insisted upon, then incorrect conclusions may easily be drawn, and comparisons of results are of little value.

The directors should satisfy themselves that the stock-taking at the end of the year links up with the records of the quantities which should be held according to the cost accountant's books. They should see that the schedules are duly certified as to quantities and prices, and they should satisfy themselves that

obsolete stock has been excluded. The example given relates to a manufacturing business, and it is therefore evident that if there is any work-in-progress it is included in the figure of stock. There should be a separate schedule of this class of stock, and the basis of valuation should be clearly indicated. The directors should enquire whether any profit has been taken in its valuation, or whether the prices represent cost only.

In businesses of the nature of contracting, building, and contract-engineering, in which the contracts are of considerable value it is usual to value contracts in hand at cost plus a portion of the profit based upon the stage of manufacture in which the work stands at the time of stock-taking. This practice is quite in order, provided ultimate profit is certain, but the directors should not allow full profit or too much profit to be taken. A conservative director will insist on the elimination of all profit from work in progress, except under extraordinary circumstances, such as might arise when the whole resources of the concern are engaged on one contract and that contract nearing completion. In cases of this description it is obvious that credit for the work and expenditure of the year spent upon the contract must be taken into the profit and loss account.

Manufacturing Expenses.

This item of expense will have been under review during the year and its constituent amounts are therefore aggregated under this heading. The charge will be supported by a summary or schedule of the various expenses and this list should be scrutinized carefully. Among the items will be found a charge for "Repairs and Renewals." This particular debit should be considered in conjunction with a schedule of all capital

expenditure carried out during the year. In this way the directors will be able to satisfy themselves that the revenue expenditure under this heading has been charged against the year's accounts and that all additions to plant accounts are of a capital nature. In the example with which we are dealing, it may be assumed that the accounts and schedules have been prepared in the following form—

SCHEDULE OF REPAIRS AND RENEWALS

(*Charged in Manufacturing Expenses*)

	£	s.	d.
"A" SHOP—			
Weighbridge—No. 6,798 .	563	–	–
Shelving and Racks .	55	–	–
Hydraulic Piping . .	57	–	–
	£675	–	–
BUILDINGS—			
Fencing and Floor Plate .	89	–	–
Crane Gauntries (Repairs) .	155	–	–
Sign Boards, etc. . .	15	–	–
	£259	–	–
FURNACES, ETC.—			
Muffle, Cupola, etc. . .	150	–	–
Furnace, Forge, and Hearth Repairs . . .	43	–	–
Japanning Stove Repairs .	49	–	–
	£242	–	–
TOOLS—			
Jigs, Saws, Dies, Moulds, Taps and other sundries.	347	–	–
GRAND TOTAL .	£1,523	–	–

CAPITAL EXPENDITURE SCHEDULE

	£	s.	d.
1. New Lathe	300	–	–
2. Cam Cutter . . .	35	–	–
3. Multi-Spindle Driller .	75	–	–
4. New Swaging Machine .	55	–	–
5. Thread Roller . .	44	–	–
6. Shafting . . .	30	–	–
7. Drop Hammer . .	159	–	–
8. Construction Wages for year	546	–	–
Total Additions to Plant Account during year .	£1,244	–	–

The portion of the charges under repairs and renewals, which must be examined in conjunction with plant account, consists of the first three items, amounting to £675. A new weighbridge has been installed at a cost of £563. If this item is an entirely new installation then its inclusion in repairs and renewals is incorrect. It is a capital addition and should be transferred to the capital expenditure schedule. It may be, however, that a weighbridge existed in the factory and that a serious breakdown rendered it unfit for service and necessitated its renewal after a

short period of service. Now the value of the former weighbridge is included in the asset account for "plant" and has been subjected only to a low rate of depreciation. The loss of the asset at an early stage of its life leaves the plant account at too high a figure, which is now rectified by the inclusion of the new weighbridge in the plant inventory and the charging of the renewal cost to revenue. Under such circumstances it is in order to charge the renewal to revenue in the manner adopted above. At this point it should be mentioned that the theoretically correct method to be followed is to write off the balance of the former weighbridge from the plant account to revenue and to capitalize the expenditure on the new one.

Treatment of Doubtful Items.

It happens frequently that in certain concerns which have paid a round sum for assets such as plant, it is impossible to link up the asset account with the plant inventory with any degree of accuracy. This difficulty also exists in other businesses in which the plant account is maintained at a round sum more or less equivalent to the value of the total plant owned. The principle to be followed in this, and in fact in every case, is to ensure that the plant account correctly represents the assets held by the business at any time. It is advisable to arrange for an independent valuation from time to time, in order to ascertain whether worthless or greatly depreciated plant is included in the balance sheet. By following these two rules, the directors will be ensuring that revenue is charged with the correct amounts each year, and that the company's property is not over-valued.

It is contended by certain authorities that there is no obligation to provide for depreciation if all renewals, replacements and repairs are charged to

repairs and renewals. Other authorities maintain that depreciation must be provided for each year because this loss must exceed the amount charged for renewals. The theory of depreciation is an involved one and will be dealt with broadly later; for the moment it is sufficient to indicate the rules which will guide directors in deciding whether to write off or to capitalize any questionable amounts.

The next item in the account is "Shelving and Racks, £55." If the shelving is not likely to last for more than a year, then it is quite correctly written off. If it consists of an addition which will last for many years then there would be no objection to its capitalization. It may be a renewal of worn out shelving, and in that case it should be written off. Similar arguments apply to the hydraulic piping, and the disposal of both items will remain in the discretion of the directors. The reasoning to be applied should follow the rule that revenue should be charged with the expenditure of the year, and that the plant account should be increased only by the value of capital additions likely to last for some years.

Occasionally, directors adopt a rule of writing off certain large items concerning which they are in doubt, and all small items, on the ground that "there will be less income tax to pay." The absurdity of this reasoning cannot be too strongly stressed. The argument is presumably based upon the supposition that depreciation and repairs and renewals charged in the accounts are allowed as charges against profits in the computation of the company's liability to Schedule "D" tax. This is not so. Repairs and renewals will certainly be allowed as a charge, but only on sufficient proof that the items are not in the nature of capital. The decisions of the directors to write off items will not affect the computation to the extent

of obtaining their allowance for income tax purposes. Depreciation of any description is not allowed as a charge, and directors should bear this fact well in mind. When they decide to depreciate assets it should be for the purpose of preparing their revenue account to show a true record of the year's results. The only allowance made in taxation computations comparable with this writing-off is a deduction for wear and tear made from an average struck, after writing back any depreciation charged by the company. Wear and tear allowances are not intended to correspond to depreciation in amount or nature, and it is therefore useless for a board to consider taxation as a guide for the charging in their accounts any repairs, renewals, amortization, reserves or depreciation.

Repairs to Buildings.

In many companies it is usual to avoid charging depreciation of buildings. Where the value of freehold buildings has risen compared with replacement cost, then there is little object in writing off small annual sums against profits. If it is desired to depreciate freehold buildings, a useful figure to adopt is the Gross Schedule " A " value which represents in theory the amount at which the property is worth to be let from year to year. This matter is mentioned at this point in order to show that the charging of small amounts similar to the £259 in the example is but a conservative practice. It may be taken as a general rule that repairs, painting, pointing and similar items of expense incurred in the upkeep of freehold buildings should be written off in the repairs and renewals account. Leasehold property requires separate treatment, and will be dealt with later. The directors should avoid capitalizing expenditure on buildings

unless it consists of tangible additions, such as the erection of new shops, outhouses, or similar constructions. There are exceptional cases of course, such as the buildings in glass-works in which the furnaces may form an integral part of the building itself, and by their depreciation cause the necessity for the renewal of the entire building containing them. In such cases it becomes necessary to depreciate the buildings simultaneously with the furnaces which affect them.

Furnaces, Etc.

Enquiry into the nature of the items given under this heading may show that the £150 spent on muffle, cupola, etc., consisted of running repairs and the use of fire bricks and similar material in patching up a furnace. From the furnaces depreciation item appearing lower in the account it is seen that one quarter of the original outlay is written off each year, and that the expected life is four years. The expenditure of £150 may have been necessary to ensure the life of a furnace for the expected term, and should therefore be charged to revenue in addition to the depreciation. The repairs to the forge and japanning stove are correctly charged to repairs and renewals.

Tools.

An amount of £347 has been debited in respect of tools. On account of the variety of items contained in a tools account, there are many accepted methods of dealing with tool purchases, each designed to avoid detailed depreciation of individual items. One of the best methods is to charge all new tools purchased to a tools account, and then to take stock of the actual tools held at the end of the year. The value of this stock is then credited to tools account and the balance is written off to revenue. If this practice has been

followed in the example set out above, then the charge of £347 was arrived at in the following manner—

TOOLS ACCOUNT

	£ s. d.		£ s. d.
To Balance at 1st January.	1,987 – –	By Value of Tools on hand at 31st December, as per inventory and valuation	2,515 – –
„ Purchases during year .	875 – –	„ Repairs and Renewals Account . . .	347 – –
	£2,862 – –		£2,862 – –
To Balance brought down	£2,515 – –		

The transfer to repairs and renewals account (£347) was made only for the purpose of collecting such charges together and debiting them in a total amount to the trading or manufacturing account. It would have been quite in order to transfer the amount to the trading account direct. Attention is drawn to the fact that this re-valuation of tools does away with the necessity for charging depreciation, for the procedure is tantamount to writing off worn-out tools. The value of the asset will therefore appear in the balance sheet at the amount arrived at in the account above, viz., £2,515.

Capital Expenditure Schedule.

Turning to the capital expenditure schedule, the director will satisfy himself that each item enumerated is in fact an addition to the asset account it affects. In the example under consideration it will be observed that the whole of the expenditure, £1,244, relates to plant and machinery account. Any items which appeared in the repairs and renewals expenditure, and which are not revenue charges should be transferred to this schedule and capitalized. Similarly, any items which might correctly be charged to profit and loss instead of being allowed to remain in the list of capital expenditure, will be transferred to repairs

and renewals. Whether the charge of £30 for shafting is regarded as a capital item, will depend upon the method the directors adopt in dealing with such items. Each board of directors will probably treat such small amounts in different ways. In the case of certain machines, for instance, there are usually many accessories and attachments supplied with the main plant which may be used for general purposes. Certain companies never capitalize these accessories, but include them in loose tools or loose plant in order that they may be depreciated by re-valuation. The practice is often extended to cover any attachment which is not fixed to the machine, and in this way it covers, for example, chucks and similar items which cannot be used except on the machine to which they were originally fitted. The principle underlying this practice is one which will well repay the consideration of the director. The classification of loose plant will naturally vary with each type of business, but in each case it is desirable to fix upon some basis of demarcation on the lines of the following example—

Example of Demarcation Suitable for the Loose Plant of an Engineering Works

(*a*) Belting, shafting and driving ropes.
(*b*) Hand tools.
(*c*) Light movable appliances.
(*d*) Light machining tools.
(*e*) Arbors, chucks and tool holders.
(*f*) Lathe carriers and other holding sections.
(*g*) Gauges, measuring appliances and testing gear.
(*h*) Jacks, trolleys, tongs and transporting plant.

The list could be continued or contracted according to the size and requirements of the business. When once settled it may be approved by the board, and will then be used as a guide by the staff in allocating

items which will not be capitalized but will be re-valued from year to year. The adoption of such a method will eliminate all small items from the capital expenditure schedule laid before the board, and will enable them to concentrate their attention on the main items appearing in that list and in the list of repairs and renewals.

Effect of Directors' Decisions.

As soon as the directors have given their decision upon these two schedules, the company's accountant or secretary will make the necessary record and the board proceeds to the consideration of the other expenses requiring their attention. The effect of the decision should be quite clear in the mind of every director. The repairs and renewals will be charged in the profit and loss account, reducing the profit, and the capital expenditure will be added to asset accounts in the balance sheet.

Reserve for Bad Debts.

£785 has been charged under the heading "Reserve for Bad Debts." The appearance of this charge in the draft accounts will inform the director, if he is not cognizant of the practice followed in his company, that the bad debts have been charged against a reserve account during the year, and that the sum of £785 is required to restore the reserve to the amount considered necessary to meet the bad debts of the succeeding year. The director must therefore make two enquiries one into the nature of the debts written off, and the other into the sufficiency or otherwise of the reserve. He should call for the list of bad debts written off, and insist upon seeing documentary evidence supporting the entries which have thus reduced one of the company's assets—sundry debtors. The sanction

of the board should be given before any debt is finally written off as irrecoverable. With regard to the reserve for bad debts, it may be stated generally that where this method is adopted the amount of the reserve is based upon a percentage of the total outstanding debts at the end of the year. Assuming that $2\frac{1}{2}$ per cent has been found sufficient during the preceding years, then the account would resemble the following example—

RESERVE FOR BAD DEBTS ACCOUNT

		£	s.	d.			£	s.	d
Dec. 31	To Bad Debts written off during year	790	12	9	Jan. 1	By Reserve brought down . . .	1,225	6	9
"	To Reserve for new year ($2\frac{1}{2}$% on £48,788) . .	1,219	14	–	Dec. 31	By Profit and Loss Account . .	785	–	–
		£2,010	6	9			£2,010	6	9
					Jan. 1	By New Reserve b/d	£1,219	14	0

It will be seen from this example that the debts actually written off during the year amounted to £790 12s. 9d. and that the new reserve consists of $2\frac{1}{2}$ per cent on sundry debtors, which stand at £48,788. An alternative method consists of the maintenance of a reserve for bad debts in a separate account and writing off the actual bad debts to profit and loss. If this method is followed then the item will be shown as "bad debts written off" in the draft accounts. It is to draw the attention of the director to the meaning of "to reserve for bad debts" that the example is set out above. He will not be under the impression that the entry necessarily means that there have not been any bad debts during the year.

Reserve for Discounts.

The charges made to customers during the year through the sales records referred to in previous

chapters are, of course, the gross amount of the invoices. The allowance of a discount may depend on many circumstances, and it would therefore be incorrect to deduct the discount before entry in the company's books. It must be remembered, however, that the inclusion of the total sales in the profit and loss account (£262,298 in the illustration) amounts to taking certain sums in account as profit, although they may never be realized. It is therefore necessary to reserve the sum of £692, representing the maximum discount which may eventually be allowed to the customers when they settle their accounts. It will be noted that the reserve is only made upon that portion of the outstanding debts which is subject to discount.

Debenture Interest.

Debenture interest, amounting to £2,500, has been charged in the draft account before arriving at profits. This is quite correct, for debenture interest is always a charge against profits. Debentures do not constitute capital; the interest upon them is payable whether there are profits or not, and the liability must be provided for. This distinction must be carefully noted, for frequent illustrations are available in which debenture interest has been treated as an allocation of profit by directors who are probably under the impression that the interest is comparable with the dividends on their own shares. Debenture interest *must* be charged before arriving at profits.

Depreciation.

The fixing of depreciation rates and depreciation methods is a matter upon which every director should be informed. In the illustration the following rates have been used—

Patents, 10 per cent. Machinery, 10 per cent.
Buildings, 3 per cent. Furniture, 5 per cent.
Furnaces, 25 per cent.

Tools have been treated by the re-valuation method.

It must not be thought that these rates are necessarily the usual rates adopted for such assets. Each board will decide upon the rates and method most suitable for each of its assets which suffer depreciation. The principal methods of depreciation are as follows—

(*a*) The Fixed Instalment Method. Under this method it is usual to divide the value of the asset by the number of years of its expected life, and to write off the amount obtained in each year's profit and loss account. This method is useful for assets which have no residual or scrap value at the end of their period of useful life, e.g. patents which expire at the end of a known term. If a patent is acquired at a cost of £1,400 and its life is fourteen years then the charge to profit and loss under the fixed instalment method is £100 per annum. This method is sometimes used for short leases, and occasionally for certain types of machinery.

(*b*) Reducing Balance Method. This method is useful for plant and machinery, furniture, fixtures, fittings and similar assets. A fixed percentage is written off the reducing balance in order to leave the asset at an amount more or less equal to scrap value at the end of the term. Under this method it is, of course, impossible to write the asset off entirely. The rate to be applied is obtained from a simple formula, which has the following effect—

If a machine cost £2,000, and has a probable life of six years with a residual value of £356 at the end of that time, then the formula tells us that 25 per cent

written off the reducing balance will leave the asset account at £356 at the end of six years. The scrap will then presumably be sold and the amount obtained will be credited to, and will close the asset account entirely.

(*c*) Annuity Method. Under this method the asset is regarded as an investment earning a certain amount of interest each year. The interest is added to the asset account, and both are written down by equal annual instalments. This method is applied to such assets as long leases, provided there is no intention of replacing the leases at the end of their period.

(*d*) Depreciation Fund Method. By this method the asset is allowed to remain at its original figure, but depreciation is charged to profit and loss, and credited to a sinking fund. At the same time, an amount of cash equal to the sinking fund instalment is withdrawn from the business and invested in gilt edged securities. When the asset is worn out the account is closed off, the securities are realized, and a new asset is purchased to replace the old. This method is usually adopted whenever it is desired to make provision for the replacement of an asset owned by the company.

(*e*) Insurance Policy Method. The insurance policy method is similar to the depreciation fund method except that the cash is applied to the purchase of an insurance policy which will provide the funds required for the replacement of the asset.

(*f*) Re-Valuation Method. This method, to which reference has already been made, consists of the re-valuation every year of such assets as tools, loose plant, etc. The new value is entered in the books and the difference between that amount and the former value is written off to profit and loss.

The Principle to be Followed.

When considering the depreciation of any asset the directors cannot do better than endeavour to charge profit and loss with an amount which must be reasonably in the neighbourhood of the loss sustained by wear and tear or effluxion of time. It is scarcely practicable to charge the correct amount in every case, for in order to do so in the case of plant and machinery, for instance, it would be necessary to take each constituent item, calculate its probable life and residual value and apply one or other of the methods set out above. The vast amount of work involved in such a procedure in large concerns precludes its adoption and it is general to substitute a flat percentage covering as many items as possible. From the point of view of financial accounting, there is no alternative to the adoption of a flat rate, but the directors may do much to minimize its errors by dividing the plant into broadly defined classes, and adopting suitable rates for each. Thus a distinction might be drawn between shop fixed plant and motive power plant, and between special process plant and transportation plant. The cost accounts of the company are designed to charge depreciation more accurately to different shops and departments than is possible in the financial accounts. By following suitable general divisions and adjusting the rates to each one, it is possible for the directors to arrive at a more or less equitable charge which will correspond to the detailed charges of the costing records. The lines of treatment must necessarily be broad on account of the limitations common to all business enterprises, and when the asset accounts are small the directors will be quite justified in applying a flat percentage each year. The effect of depreciation funds and sinking funds upon the balance sheet is dealt with in Chapter VI.

Net Profit.

The balance of net profit amounting to £49,182 in the draft account will be adjusted to conform with the decisions of the directors upon the points enumerated, and will then be transferred to an appropriation account, which will be dealt with in the next chapter.

CHAPTER XVIII

THE ALLOCATION OF PROFIT

As soon as the draft revenue account has been approved, the balance of profit (if any) is transferred to an appropriation account for disposal. It may happen that certain appropriations have been made during the year, in which case they will be set out in detail as diminutions of the available balance. Items of this nature would be appropriations for dividends declared at the previous general meeting, the allocation of sums to reserve, or the payment of interim dividends. In the illustration of a revenue account in the previous chapter, a charge was made against the profits for directors' fees. That charge was correctly made, provided the Articles laid down that the directors should receive that amount of remuneration. Had the Articles been silent on the matter, then any payment voted at the previous meeting would be in the nature of an *ex gratia* payment, and would then appear in the appropriation account, and not in the profit and loss account as shown. This point furnishes a good illustration of the method by which a director may decide whether a payment is a charge against profits or an appropriation.

The draft appropriation account given at the foot of the next page contains several items which constitute allocations of realized profits.

Distributions Since Last Meeting.

In order to understand the following example, it is necessary to note that when the previous accounts were laid before the shareholders the balance sheet contained on the liabilities side a credit balance on

profit and loss of £3,613 plus £53,456, a total of £57,069. The payments on the debit side to the managing director, the staff, the dividends to the shareholders, etc., were ordered to be made by the proprietors; in other words, the shareholders allocated £49,000 of the available profits, and ordered that £8,069 should be carried forward to the current year. Knowing that the current year's accounts would reveal a profit exceeding £15,000, the directors declared an interim dividend of that amount, which reduced the balance of £8,069 plus the current year's profit of £49,182, shown by the profit and loss account in the preceding chapter, to an available balance of £42,251. It is this latter amount which will appear in the new balance sheet, and which will be disposed of by the shareholders in the general meeting. They will doubtless follow the recommendations of the directors who must now consider the best method in which the profit should be employed or paid away.

Transfer to General Reserve.

As previously explained, a general reserve has for its object the retention of funds in the company itself

APPROPRIATION OF PROFITS ACCOUNT

Date		£	*Date*		£
	To Honorarium to Managing Director voted at last Annual General Meeting . . .	1,000		By Balance brought forward	3,613
	To Bonus to Staff, (do.) .	1,500		By Profit for year brought from Profit and Loss Account . . .	53,456
	To Transfer to General Reserve Account . .	15,000			
	To Transfer to Loan Redemption Fund Account	1,500			
	To Dividends declared at last meeting . .	30,000			
	To Balance carried forward	8,069			
		£57,069			£57,069

Date		£	*Date*		£
	To Interim Dividend declared by Directors .	15,000		By Balance brought forward	8,069
				By Profit for year transferred	49,182

for the purpose of strengthening the financial position, conserving working capital, etc. The effect of a transfer of profit to a general reserve should be borne in mind by the director when deciding upon the amount to be proposed to the proprietors for conservation. Such an allocation acts as follows—

BALANCE SHEET

BEFORE TRANSFER TO GENERAL RESERVE

Liabilities	£	*Assets*	£
Capital	500,000	Sundry Assets other than Cash.	450 000
Profit and Loss . . .	50,000	Cash	100,000
	£550,000		£550,000

BALANCE SHEET

AFTER TRANSFER TO GENERAL RESERVE

Liabilities	£	*Assets*	£
Capital	500,000	Sundry Assets other than Cash.	450,000
General Reserve Account .	20,000	Cash	100,000
Profit and Loss . . .	30,000		
	£550,000		£550,000

It will be observed that the allocation will not affect the assets in any way. The effect of the transfer is to leave a smaller amount of profit available for distribution by way of dividend. Had the allocation not been made then the shareholders might have been tempted to order the distribution of the whole of the credit balance on profit and loss, thus reducing the cash to £50,000. By agreeing to retain £20,000 of the profit in the business, the cash resources can only be depleted by a maximum of £30,000. The question whether the shareholders can override the recommendation of the directors as to the amount of dividend which can be paid is ignored for the moment. It is sufficient to bear in mind that a transfer to reserve of an amount calculated to leave only sufficient profit to cover the dividends which the directors deem it

expedient to distribute will remove an opportunity for the expression of dissatisfaction with the smallness of a dividend. Many shareholders are prone to complain of the smallness of dividends whenever the amount they receive leaves a considerable sum to the credit of profit and loss account.

Dividends and Cash.

One elementary point emerges from the illustrations given above. It is a simple matter, but one upon which directors frequently stumble. The amount of cash in hand has nothing to do with the amount of dividend which can be declared, except that it will naturally set a maximum to the total distribution. The maximum dividend is limited by the credit balance on profit and loss account. In the above examples, therefore, it must be observed that the total dividend cannot exceed £50,000 in the first case, and £30,000 in the second, in spite of the fact that there is an amount of £100,000 in the bank. The truth of these points will be readily understood when it is remembered that it is quite possible for a company to possess £100,000, and yet be unable to pay any dividend on account of the fact that its profit and loss account is in debit, as in the following example—

BALANCE SHEET

Liabilities	£	*Assets*	£
Capital	500,000	Sundry Assets . . .	400,000
Creditors	50,000	Cash at Bank . . .	100,000
		Profit and Loss Account . .	50,000
	£550,000		£550,000

Reserve Fund.

The directors may decide to transfer certain of the available profits to a reserve fund, as distinct from a reserve account, and in that case they must consider

the effect on the balance sheet, noting the manner in which the allocation differs from that set out above—

BALANCE SHEET

BEFORE TRANSFER TO RESERVE FUND

Liabilities	£	*Assets*	£
Capital	500,000	Sundry Assets . . .	500,000
Profit and Loss . . .	50,000	Cash at Bank . . .	50,000
	£550,000		£550,000

BALANCE SHEET

AFTER TRANSFER TO RESERVE FUND

Liabilities	£	*Assets*	£
Capital	500,000	Sundry Assets . . .	500,000
Reserve Fund . . .	20,000	*Investments representing the Reserve Fund*	20,000
Profit and Loss . . .	30,000	Cash at Bank . . .	30,000
	£550,000		£550,000

It will be observed that in this case cash is taken from the business and invested in outside securities. The object of the procedure is to effect the laying aside of surplus capital for which adequate use cannot be found in the company itself. The securities chosen are, of course, gilt edged in order that they may be realized without loss of any appreciable time or capital should occasion demand. A reserve fund is never opened unless the cash to be transferred is quite surplus to requirements. It would be an error of judgment, for instance, to transfer cash to a reserve fund to earn a low return of interest if the cash could be utilized in obtaining a higher return by way of cash discounts from the company's creditors.

Loan Redemption Fund.

Turning once more to the specimen appropriation account, it will be noticed that a sum of £1,500 was allocated after the preceding general meeting to a loan redemption fund account. The word "fund"

in the title of this account indicates that cash was withdrawn from the business and invested in outside securities in the same manner as that adopted for a reserve fund. A loan redemption fund is one of a class of accounts known by the general description of "sinking fund." There are two classes of sinking fund, and the director must understand the purpose of each very clearly. One class of sinking fund is built up for the purpose of providing cash at a later date for the replacement of an asset, such as, for instance, the purchase of a new lease upon the expiration of the old. The other class of sinking fund is built up for the purpose of meeting a known liability which will fall due at a later date, such as, for instance, the repayment of loans or debentures. The principal point in which these two funds differ one from another is that the sinking fund for the replacement of an asset is a charge against profits, whereas the sinking fund for the settlement of a liability is an appropriation of profit. The effect of the first class of sinking fund upon the balance sheet may be illustrated as follows—

BALANCE SHEET

BEFORE CREATION OF THE FUND

Liabilities	£	*Assets*	£
Capital	500,000	Sundry Assets . . .	400,000
Profit and Loss Account .	50,000	Leasehold Premises . .	50,000
		Cash at Bank . . .	100,000
	£550,000		£550,000

BALANCE SHEET

AFTER FIRST CONTRIBUTION TO LEASEHOLD REDEMPTION FUND

Liabilities	£	*Assets*	£
Capital	500,000	Sundry Assets . . .	400,000
Leasehold Redemption Fund Account	2,000	*Leasehold Premises* . . .	50,000
Profit and Loss Account .	48,000	*Investments against Leasehold Redemption* . . .	2,000
		Cash at Bank . . .	98,000
	£550,000		£550,000

When the final instalment to the fund has been made, and the leasehold premises are no longer in the possession of the company, the investments are realized, and the resulting cash is available for the purchase of a new lease. The balance sheet would then appear as follows—

BALANCE SHEET

Liabilities	£	*Assets*		£
Capital	500,000	Sundry Assets		400,000
Profit and Loss Account	50,000	Cash at Bank	£100,000	
		Add Proceeds of Investments	50,000	
				150,000
	£550,000			£550,000

Funds to Replace Assets.

Similar procedure will be followed in building up funds for the replacement of other assets which waste away or are gradually consumed in the process of earning revenue. As the method constitutes one of the principal classes of depreciation previously outlined, it may be used for any asset, but it is usual to confine its application to assets of some magnitude. It must be borne in mind that the contributions to any fund in the nature of depreciation must be charged to profit and loss account, and *not* to the appropriation account.

Funds to Meet Liabilities.

Sinking funds for the repayment of liabilities follow the same procedure as that outlined above. When the time arrives for the repayment of the loans, debentures or other liability concerned, the investments are realized, and the cash is paid over to the original lenders. When this has been done the balance sheet will differ from that in which an asset is replaced, for the fund on the liabilities side will still remain. In the former example the fund account disappeared,

for it was closed off to the old asset account. In this case the balance sheets will appear as follows—

BALANCE SHEET

BEFORE REPAYMENT OF THE LOAN

Liabilities	£	*Assets*	£
Capital	500,000	Sundry Assets . . .	500,000
Loan Redemption Fund . .	50,000	*Investments against Loan Redemption*	50,000
Loans	50,000	Cash	100,000
Profit and Loss . . .	50,000		
	£650,000		£650,000

BALANCE SHEET

AFTER REPAYMENT OF THE LOANS

Liabilities	£	*Assets*	£
Capital	500,000	Sundry Assets . . .	500,000
Loan Redemption Fund Account	50,000	Cash at Bank . . .	100,000
Profit and Loss . . .	50,000		
	£600,000		£600,000

The investments have been turned into cash and paid over to the lenders of the £50,000. The directors must now decide upon the disposal of the fund account on the liabilities side of the balance sheet. Now this account has been built up from appropriations of profit, but the cash has been utilized in paying off a capital liability. The procedure to be followed then is to turn the account into a reserve account. As the cash represented by these appropriations has been disbursed, the account should be treated in theory as a capital reserve account and not utilized for payment of dividends. The reason for this step is that the cash is no longer available for distribution among shareholders. The account is now represented by other assets which cannot be utilized for dividend purposes.

The director will now be in position to work out for himself the effect of any appropriations of profit upon the balance sheet. It is only necessary to grasp the two-fold action of every transaction and to re-construct the draft accounts to show the position of the company if suggested schemes are carried out.

CHAPTER XIX

THE GENERAL FORM OF ACCOUNTS

THERE remains to be considered the general form in which the accounts will be laid before the proprietors. It is unfortunate that none of the movements of recent years for standardization of accounts has been successful to any great extent. The latest attempt, that set afoot by the Rubber Shareholders' Association, met with some degree of enthusiasm, but it remains to be seen whether the suggested scheme put forward by that association will be adopted in practice. The aim of the promoters of standardization schemes is to ensure that the directors of all companies in particular trades set out their accounts in more or less the same general form. Two main objects are taken into account—firstly, the providing of sufficient information to the shareholders to enable them to realize the exact state of their company, and secondly, to prevent competitors from gleaning too much information from published accounts. These two objects naturally clash, and as the directors of most companies are usually only too ready to observe the second clause—the concealment of information from competitors—the movement towards standardization resolves itself into a plea for refraining from concealing too much from the shareholders. The fact that these movements will become more and more insistent as time goes on must be accepted by the directors of all public companies, and they would do well to study conscientiously every clause in the opening memorandum of that particular association to which reference has just been made.

The sponsors say: "We submit the following postulates which are, in our opinion, fundamental—

"(1) The object of all book-keeping should be the providing of a true and complete statement of affairs at any given date.

"(2) The owners of a business are entitled to the information provided by correct book-keeping.

"(3) In the case of a joint stock company, the owners are the shareholders."

These three postulates appear at first sight to be only the iteration of three truisms. Closer inspection will show the director that they are complementary and contain within their sentences sufficient food for thought to occupy the director for a considerable while. Let him realize their import and then, and then only, proceed to frame his accounts for submission to his shareholders.

Secret Reserves.

It has been demonstrated that the principal points to which a director must give his attention after the balance of profit has been struck concern the disposition of reserves and funds. The effect of these allocations has been set out fully in the preceding pages. With broad principles in mind similar to those just quoted from the Rubber Shareholders' Memorandum, we may proceed to the consideration of the concealment of profits and the concealment of losses. The manner in which the first is carried out consists of the creation of secret reserves. A secret reserve is usually created by excessive writings-off, depreciating assets at too high rates and occasionally by eliminating purchases of new assets from the balance sheet. From a commercial point of view there is undoubtedly a lot to be said for secret reserves. They have been the means of warding off much unnecessary anxiety;

they have assisted in the equalization of dividends and in the support of the stability of those undertakings in which public confidence forms no inconsiderable portion of goodwill. On the other hand, they have many serious disadvantages, and the director must weigh all the circumstances before consenting to the suppression of facts in his accounts. The most serious disadvantage of secret reserves is that they tend to destroy confidence in certified trading results as soon as the shareholders learn by implication or by direct information that they exist. Suspicion is aroused that the steady increase in net profits is not necessarily the actual variation from year to year, but the effect of secret provision for reserves in good years and equally concealed writing back in lean years.

In principle there should be no such item as a secret or cellar reserve. The fact that the proprietors of a limited liability company have sunk their individuality in a corporation capable of suing or being sued as a separate legal *persona* should not affect their rights as a body of shareholders to full knowledge of the conduct of their own affairs. The director may wonder why the word "should" is used; it is introduced advisedly, for the legal view of secret reserves is far from definite and does not entirely accord with accepted accounting principles. This explains the reason why the creation of secret reserves still remains a matter of discretion with the directors of public companies. One very important case on the subject (*Newton* v. *B.S.A. Ltd.*) provides that it is not illegal to withhold certain information from the shareholders, though it is *ultra vires* to attempt to forbid auditors to report on all matters connected with the accounts. The judgment of Buckley J. in that case further indicated that the shareholders are not entitled to full information on certain items if the

Articles authorize their non-disclosure, and that the auditors are not bound to disclose that the position of the company is in fact healthier than would appear from the published accounts.

It would seem then that the shareholder may not only be kept in ignorance of the existence of reserves created by excessive depreciation, but he may also be kept unaware of the existence of reserves in the form of assets purchased and charged to profit and loss account. It will be seen that the question of such reserves affects the director to a far greater extent than any other officer, and that it is a thorny problem fraught with danger, and calling for careful consideration.

At one time it was a practice to set out a statement on the balance sheet enumerating assets which were held but excluded from the accounts. This disclosure was a compromise between the orthodox full statement with its attendant risks of loss of goodwill in lean years, and the other extreme of holding up specific assets from the accounts with the rather more dangerous risk of misapplication of the hidden assets, or *ultra vires* expenditure. This compromise has now fallen into disfavour, and at present it is safe to say that in the majority of cases in which secret reserves do exist they are, in fact, secret. It is impossible to lay down any definite rules for the guidance of the director on the question. The matter can only be explained and left to the conscience of the individual to deal with as he thinks best when the time arrives for him to give a decision. There is one consolation to be found in the thought that the creation of secret reserves may often be a wise course, and at the same time a reprehensible course, but rarely will it resolve itself into a criminal course as will its counterpart—the concealment of losses.

Concealment of Losses.

It is unfortunately necessary to deal with the concealment of losses, a temptation to which many boards continually succumb. The practice appears to divide itself into two classes—one, concealment of loss by deliberate fraud with intent to mislead, to cover misdeeds and to deflect suspicion from the acts of directors who use the cloak of joint stock enterprise to cover their misappropriations; the other class of concealment is not so reprehensible, but is equally to be deplored. It consists of strained attempts so to present accounts that the sad story of mis-direction is not apparent to the proprietor. There is a difference between this concealment and the perfectly honest course of striving to prevent unnecessary alarm among the company's creditors. It might easily happen that the balance sheet of a perfectly sound company presented in detail at a time of temporary shortage of working capital could so alarm creditors as to destroy goodwill in a comparatively short space of time. The term "concealment" is not applied to the practice adopted in such cases, of condensing accounts in a manner which will not create useless embarrassment. The term is applied only to that concealment which has for its object the deception of shareholders without necessarily the intent to defraud them of their property. Unfortunately, the excuse of "not wishing to give information to competitors" may be used—and is used—to cover all classes of concealment and is particularly useful to cover inefficient management.

Whenever the director is requested to agree to non-provision of depreciation in any year he should be very careful to ascertain the reason for the proposal. He may be informed that certain assets have been re-valued and that an excess of the valuation over book

figures has been used in the "general improvement" of the balance sheet. He must be fully informed on the nature of the "improvement." It may be that an intangible asset has been written off against excess valuation of plant and machinery. Such a transaction may not require much investigation or consideration, but it should not be forgotten that less scrupulous directors might have used the excess to increase the general revenue balance. There will not be much danger of such concealment if the director keeps the real control in his own hands. If the preparation of the accounts has been left to a committee, then it is the duty of the director to ensure that the profits disclosed are really revenue profits, and that they have been actually earned.

Losses of Subsidiaries.

A very important matter connected with the concealment of losses is the manner in which losses of subsidiaries should be dealt with. It is perhaps but natural that the board of a parent company unfailingly arranges that every available profit arising on the accounts of subsidiary companies is declared as dividend, and that full reference to the fact is made in the published accounts and report. The same desire to provide full information is not always evinced when the subsidiaries have made losses. Often the associated companies are left to carry their own debit balances and the parent company continues to pay dividends from its own profits without making adequate provision for the losses sustained in its own investments. The legal arguments concerning the separate identity of subsidiary companies are too lengthy to be examined in full; suffice it to say that they may be used speciously to excuse provision for subsidiary losses in the accounts of parent

companies. This is a matter in which the director might well disregard the legal niceties whereby he may cover his conduct in ignoring such losses. It is a matter in which he should undoubtedly pursue the honest course, face facts and refrain from empiricism. He should remember that although he may agree to make no provision for these losses and excuse himself by maintaining that the intrinsic value of the investments in subsidiaries is sufficient to cover a certain amount of loss, yet this excuse is based only upon an opinion. Should occasion arise upon which he is called upon to justify his opinion, he may find some difficulty in bringing his opinion into accord with the actual facts. The safest frame of mind in which to approach the problem is to ignore the fact that the subsidiary companies are separate entities in the eyes of the law. If they are wholly owned, then the director should regard the whole group as a single company possessing the aggregate assets, and indebted to the creditors for the aggregate debts. The investment in the subsidiaries will be excluded from the parent company's balance sheet in this mental procedure, and the issued capital of the subsidiaries will be excluded on the other side. The balance sheets may then be formed into a composite statement which must necessarily give a more correct account of the state of affairs than the separate and unconnected balance sheets. If the director bases his decisions upon such a composite balance sheet he will be less likely to commit errors of judgment.

Reserves for Subsidiaries' Losses.

Many companies now follow the commendable practice of making a reserve in their own accounts every year for any losses sustained by subsidiary companies. If this is done then there is no need to

reveal the amounts or to draw attention to the fact by actually writing down the investment account. The cases in which concealment should not take place are those in which the subsidiary accounts are ignored and the investment account left at inflated values. Whether such half-hearted practices as the insertion of a note on the balance sheet to the effect that "No provision has been made for losses in subsidiary companies" constitutes disclosure to the proprietors can only be a question of fact to be determined by every director sanctioning the practice.

Condensing the Revenue Account.

The reader will be well aware of the practically universal method of suppressing the trading account, condensing the profit and loss account and giving only in complete form the appropriation account. The reason given for this elimination and condensation is the well-worn phrase about giving information to competitors. The suppression of accounts certainly prevents competitors from gaining information; that fact cannot be denied. What information they could gain from the usual revenue account is a question to which the authors have been unable to obtain a reasonable answer. In fact, it will be found that but one excuse can be given—that the rate of gross profit can be ascertained by any competitor. Assuming for a moment that the trading account could not be cast in such a way as to conceal the gross rate of profit, it may be mentioned that satisfactory means exist of ascertaining gross profit percentage in trade practice prices without resorting to calculations based upon figures which may contain items quite foreign to the particular trade concerned. It may generally be assumed that the sales managers of competing firms

BALANCE SHEET OF THE ______________________ COMPANY, LIMITED,

MADE UP TO THE ____________ DAY OF ________________ 19__

Capital and Liabilities.

			£ s. d.	£ s. d.
I. Capital.		Showing—		
	1	The number of Shares . . .		
	2	The amount paid per Share . .		
	3	If any arrears of Calls, the nature of the arrears and the names of the defaulters		
	4	The particulars of any Forfeited Shares		
II. Debts and Liabilities of the Company.		Showing—		
	5	The amount of Loans on Mortgages or Debenture Bonds . . .		
	6	The amount of Debts owing by the Company, distinguishing—		
		(*a*) Debts for which acceptances have been given . . .		
		(*b*) Debts to tradesmen for supplies of stock-in-trade or other articles		
		(*c*) Debts for Law Expenses . .		
		(*d*) Debts for Interest on Debentures or other Loans . . .		
		(*e*) Unclaimed Dividends . .		
		(*f*) Debts not enumerated above .		
VI. Reserve Fund.		Showing—		
		The amount set aside from profits to meet contingencies . . .		
VII. Profit and Loss.		Showing—		
		The disposal balance for payment of Dividend, etc.		
Contingent Liabilities.		Claims against the Company not acknowledged as debts . . .		
		Moneys for which the Company is contingently liable . . .		

Property and Assets.

			£ s. d.	£ s. d.
III. Property held by the Company.		Showing—		
	7	Immovable Property, distinguishing—		
		(*a*) Freehold Land . . .		
		(*b*) " Buildings . .		
		(*c*) Leasehold " . . .		
		Movable Property, distinguishing—		
	8	(*d*) Stock-in-Trade . . .		
		(*e*) Plant		
		The cost to be stated, with deductions for deterioration in value as charged to the Reserve Fund or Profit and Loss		
IV. Debts owing to the Company.		Showing—		
	9	Debts considered good for which the Company hold bills or other securities		
	10	Debts considered good for which the Company hold no security . .		
	11	Debts considered doubtful and bad .		
		Any debt due from a Director or other officer of the Company to be separately stated		
V. Cash and Investments.		Showing—		
	12	The nature of Investment and rate of interest		
	13	The amount of Cash, where lodged, and if bearing Interest . . .		

know as much about the company's business as its own sales manager knows about theirs.

These observations might be extended, but the practice of elimination of trading and profit and loss accounts is unfortunately too much of a fetish to be influenced at the present time. The standardization of accounts is too far from being accepted in principle for any remarks on detail to serve a useful purpose.

Condensation of the Balance Sheet.

The condensation of the balance sheet is resorted to by some companies to a greater extent than by others. There does not seem to be the same frantic endeavour to make the practice universal, as in the case of the revenue accounts. Many companies certainly give all fixed assets in one composite figure, including plant, buildings, goodwill and investments. Others carry the idea a little further and include one floating asset—stock. Probably there are reasons for this grouping. It certainly hampers enquiring shareholders who may endeavour to assess the value of their investment from the meagre information afforded. It is not a practice to be recommended to the director who is compiling his accounts for the first time. He may quite reasonably group some of the assets, but the grouping should follow some ordered reasoning. A good example to follow is that provided in the original Table " A ." The director should examine that example and then turn to the case of *Galloway* v. *Schill, Seebohm & Co., Ltd.* From these two sources he will glean sufficient information to guide him in the avoidance of over-condensation.

The specimen balance sheet of the original Table " A " is given in the inset, whilst the reference to the *Galloway* v. *Schill, Seebohm* case may be explained as follows: Sec. 26 of the Companies

(Consolidation) Act, 1908, provides (*inter alia*) that the annual summary of a company which must be filed at Somerset House shall contain a statement in the form of a balance sheet, audited by the company's auditors, giving a summary of capital, liabilities, and assets, disclosing the general nature of the liabilities and assets and stating how the value of the fixed assets has been arrived at. In *Galloway* v. *Schill, Seebohm & Co., Ltd.*, the defendants gave the whole of their fixed assets in one line and one sum. They were ordered by the Court to make their return in such a form as to show the value of their fixed assets under three separate heads—

(*a*) Buildings.
(*b*) Goodwill and trade marks.
(*c*) Machinery, fixtures and furniture.

This case, considered in conjunction with Sec. 26, will guide the director in the general setting out of the balance sheet of his company.

CHAPTER XX

MEETINGS, ANNUAL GENERAL MEETINGS AND SPEECHES TO SHAREHOLDERS

OCCASIONAL references have been made throughout the preceding pages to the meetings of directors. It is now necessary to deal more particularly with the conduct of meetings, especially of those at which the shareholders are present. We will assume that the accounts of the company have been dealt with and they are now in print for circulation to the shareholders. The directors have given a brief outline of the salient points in the company's history during the year in the form of a report printed on the first page of the notice calling the shareholders together. The additional information will be given at the meeting itself and it is essential, therefore, that the director should be thoroughly acquainted with the procedure to be followed.

Classes of Meetings.

The meetings of directors do not fall into any defined classes but there are three distinct classes of meeting of shareholders, namely, the statutory meeting, the ordinary general meeting and the extraordinary general meeting.

Directors' Meetings.

The meetings of directors are termed board meetings but there is no settled code of procedure governing them. It is only necessary for the directors to act as a board and not as individuals and it is quite possible for a board meeting to take place under informal circumstances. In the strictly legal sense, it may be said that directors cannot think without

meeting, and in the *Portuguese Consolidated Copper Mines* case of 1889 it was mentioned that the directors must meet in order to act together and that it is not sufficient to procure the separate written authority of a number of directors to any matter, however unimportant. How far this opinion holds good to-day is uncertain ; it is customary, at any rate, to include a provision in most Articles of Association that a resolution committed to writing and sent round to every member of the board for signature shall have the same force as a resolution passed at a meeting duly convened. There are undoubtedly many dangers attending this provision and the director would be well advised to see that it is made a rule that such resolutions are brought forward for confirmation at the next subsequent meeting. As a matter of interest, it may be mentioned that Articles of Association including this clause as to written resolutions are not acceptable to the committee of the Stock Exchange when they are considering applications for quotation.

Informal Directors' Meetings.

It was mentioned above that the meetings of directors may be held under informal circumstances. It is important to observe, however, that casual meetings of directors even at the office of the company cannot be called board meetings against the wish or intention of any member or members meeting casually in this way. If the Articles stipulate that notice of board meetings must be given, then casual meetings cannot be held to be board meetings unless proper notice has been given.

Proceedings at Directors' Meetings.

The agenda for the meetings of directors is usually prepared by the secretary in consultation with the

chairman. The directors are not bound to take the business in the order of the agenda; they may deal with the matters arising in any order they please. This point was laid down in the case *re Cawley*, 1889, and is one which may easily be one of importance should any actions arise in which the acts of the directors in the conduct of the company are questioned. The director should, therefore, note his right in this matter.

The quorum for a directors' meeting is usually fixed in the Articles. If it is not fixed then it consists of a majority of the board present and willing to act.

Reference has been made to cases in which the Articles forbid directors to vote upon matters in which they are interested in a capacity other than that of director. This point must be borne in mind in connection with a quorum at board meetings; whenever a director is present at a meeting at which contracts for his own benefit are under consideration he cannot be counted in the quorum. This rule will not prevent the director from voting as an ordinary shareholder at general meetings when such contracts are laid before the proprietors for acceptance.

Directors' Minutes.

Every company is bound to keep a minute book of its proceedings at general meetings and of the meetings of its directors or managers. The minute book is prima facie evidence of the transactions of the meetings and should be open to the inspection of all the directors, the secretary and the auditors of the company. Attempts have been made upon occasions to prevent inspection of the minute book by the auditors on the ground that it is not a book of account. This is quite wrong and should not be seriously entertained

by any director. The minute book is *not* open to the inspection of the shareholders.

The Statutory Meeting.

The statutory meeting is the first important meeting the director is called upon to attend. It is a meeting of all the shareholders called together not less than one month and not more than three months from the time the company is entitled to commence business. Its object is to acquaint the shareholders with the exact position of the company, and though it is usually of a formal nature it is obligatory to forward a report to the members at least seven days before the meeting. This report is certified by not less than two directors and sets forth the number of shares allotted, the amount of cash received, and certain details concerning preliminary expenditure and contracts into which the company is entering. One result of this meeting is to acquaint the shareholders whether sufficient cash has been received to enable the company to pursue the objects set forth in the Memorandum. The meeting is at liberty to discuss any matter relating to the formation of the company, the prospects of the company and any matter arising out of the statutory report.

Extraordinary Meetings.

Extraordinary general meetings are meetings of the shareholders other than the statutory meeting or the ordinary general meeting. They are held for the purpose of dealing with extraordinary matters outside the usual business of the company, and they may be called by the directors in accordance with the Articles or on requisition of the members or they may be called by the shareholders themselves if the directors fail to convene.

Ordinary General Meetings.

It is with the ordinary general meeting that the director is most concerned, and the detail surrounding the procedure to be observed will be set out at greater length. The ordinary general meeting must be held once in every calendar year and not more than fifteen months after the last preceding ordinary general meeting. Failure to hold this meeting renders every officer liable to a fine not exceeding fifty pounds. The Articles provide the method by which the ordinary general meeting is to be convened, and it is usual for them to stipulate that the meeting shall deal with such matters as the re-election of directors, auditors and so on.

The first step usually consists of holding a board meeting, at which directions are given for the calling of the ordinary general meeting. This directors' meeting will be the one at which the accounts are passed for publication as explained in the previous chapter. The secretary then takes steps to print the accounts and to dispatch copies to the members on the register. The insertion of the time and place of the meeting is usually left by the Articles to the discretion of the board. It is not uncommon, however, for the Articles to stipulate that a certain amount of notice shall be given—generally seven days.

The details surrounding the summoning of an ordinary general meeting are not fixed and identical for all companies. The particular Articles of each company must be followed and there will, therefore, be no harm in advising the director to cast aside the very general idea that the annual general meeting is hedged by numerous legal requirements and that it consists of little else but the fulfilment of demands laid down by the Companies Acts.

This point is introduced in order to stress a matter

which often escapes the director when preparing to attend his first general meeting—namely, that the success of joint stock enterprise is undoubtedly enhanced whenever boards of directors regard the occasions upon which they meet the shareholders, as opportunities for acquainting them fully and even informally of every possible item of interest to which the proprietors are entitled. Too often is the general meeting invested with a solemnity and with a legal significance which prevents the director from presenting a frank and open front to the enquiries of those whose interests he is appointed to safeguard.

To return to the formalities connected with the calling of the general meeting, it is sufficient if the directors consult the Articles. The law will not interfere with the internal management of a company, and, in the matter of fixing the date of a general meeting, or the manner in which notice is given, the board need only refrain from fixing dates with the object of preventing shareholders from exercising their voting powers. This item connected with general meetings has been dealt with at some length in order to insist upon the importance of observing the maxim that every assistance should be given to the shareholder to meet the directors upon the very occasional opportunities presented to him.

Contents of the Notice. It was mentioned above that the Articles often stipulate that specified matters shall be dealt with at general meetings. Somewhat similar rules govern the compiling of the notices. Here again the director should see that any express rules in the Articles as to the contents of the notice are observed. If, in addition to this, he adopts the method of ensuring that the notice of a meeting—ordinary or extraordinary—gives the recipient sufficient information to permit him to judge whether he

should make a special point of attending, the director will have done his duty. The notice should show clearly whether the agenda consists of none but routine business or whether matters of importance will come up for discussion. If a notice does not give sufficient detail of "general business" to show that certain of the business is of great importance then the meeting may be invalid and any resolutions purported to have been passed may subsequently be declared void (*Normandy & Co.* v. *Ind, Coope & Co.*, 1908).

THE CHAIRMAN. The chairman of the annual general meeting is usually the chairman of the board of directors but not necessarily so. It must not be imagined that chairmanship of a board carries with it a right to the chair of the shareholders' meeting. The Articles generally provide that the chairman of the board shall take the chair at the general meeting and in that case he takes charge of the meeting as a matter of course. If the Articles are silent then the Act allows the election by the members of any person to preside over their own meeting. It is perhaps regrettable that the Articles of Association of companies generally set out detailed provisions on the matter of chairman of the general meeting. It is only in those companies which permit the shareholders to choose a chairman that the one upon whom their choice falls controls the meeting with a true conception of his position. The chairman is always the representative of the shareholders at a general meeting; he collects his authority from the *members* and not from the board; the members, and not merely the board of directors, have given him the power to control those present at the meeting.

Unless the Articles lay down rules for the conduct of the meeting the director must, on his own

responsibility, preserve order, see that the proceedings are carried out in a proper manner and ensure that the true feeling of the members is ascertained in connection with each point laid before them.

READING THE NOTICE. It is customary to commence the meeting by calling upon the secretary to read the notice convening the meeting. This practice is not required by statute but it is useful—as also is the less usual practice of reading out the previous minutes—as a means of permitting the directors, and particularly the chairman, to settle down before commencing their speeches. The next matter is the reading of the auditor's report. In this case it is necessary that the remarks of the auditor shall be actually read out to the meeting in order to comply with the Act. The reading of the accounts is usually omitted because each shareholder has a copy. The formalities concluded, the chairman makes his speech, explaining the affairs of the company and providing as much additional information as he can. He concludes his speech by formally moving the adoption of the accounts. Another director seconds and the meeting is thrown open to discussion, the shareholders being invited to ask questions upon, or to criticise, the report, accounts and speech. Whenever the temper of the meeting runs high the chairman must keep a firm hand and be insistent upon any rulings he makes. He should firmly refuse all dilatory resolutions and amendments and, without appearing to be antagonistic, repress unruly spirits, urging them to air their grievances in a reasoned manner.

It will usually be found that the cry at troublesome meetings is for the appointment of a committee of inspection, coupled with all manner of amendments to the motion to pass the accounts. Whenever this common trouble arises it is well for the director to

note that a committee of inspection can be appointed only by a special resolution, and that it is also doubtful whether an informal committee, as distinct from a properly constituted committee of inspection, can be delegated except by a motion upon which all the shareholders have had a chance of voting. It is usually a simple matter, then, to quash insistent demands for the appointment of a committee, for any attempt to do so becomes void whenever notice of the special resolution has not been given to the members previously. In spite of this fact, however, it is unwise for a board to resist an honest attempt to investigate the accounts of the company. If all is in order then the fact that a committee carries out an enquiry can only enhance the prestige of the board when the committee's report is presented to the members.

It is advisable to point out to the members that a demand for a committee except on a special resolution is of no avail, but that the directors would welcome an informal delegation chosen from among the members and that the delegation would be given every assistance by the board. It is a most inadvisable proceeding for any chairman or director to endeavour to ward off enquiry by threatening to resign if an appeal for a committee is persisted in. This practice is rife and is in some degree responsible for the feeling of injustice with which many shareholders depart from annual general meetings.

Personal Apologies. There is perhaps no more unfortunate aspect of annual general meetings than the growing tendency to occupy the time and attention of the proprietors with the personal explanations and apologies of individual directors. The habit appears to be widespread during the periods of depression immediately following a boom in trade. These periods inevitably reveal cases of shortsighted policy and

demonstrate that although it may be profitable to entrust the direction of a company to all and sundry persons during times of brisk trade, it is possible that the temporary profit will be lost as soon as the period in which it was impossible not to make profits is past and over. Such times emphasize the distinction between direction and speculation. As far as the director is concerned there is no necessity whatever for him to make excuses to the shareholders for his own lack of judgment. He is but the officer and servant of a separate legal *persona*—the company—and the members must expect to suffer for errors of judgment or inefficiency of those they appoint. If the director feels that the responsibility is his, then he can take no better course than that of resigning and thus safeguarding the company from further possible losses on account of his own admitted shortcomings. If his fault consists of inefficiency then personal apologies are quite unnecessary ; if he has been guilty of acts in the nature of misfeasance, as distinct from innocent incompetence, then the shareholders will require an explanation from him under different circumstances from those obtaining at a general meeting, and probably before a court.

Another custom which has little to recommend it, but which appears to have gained some degree of popularity, is that of offering to make good a dividend when the results of a company's trading prove otherwise than was predicted in a prospectus. This custom is sometimes followed by the vendor-directors of a business and is designed to counter the inevitable disappointment of those who placed their trust in optimistic forecasts of handsome dividends. The habit is an unnecessary one. The vendors are under no obligation to make gratuitous offerings to companies and if they do so they are apt to be misunderstood

and in any case they are doing much to undermine the principle of independent constitution which is at the base of all joint stock finance. When prospectus forecasts are not realized the public have only themselves to blame for permitting the vendors to take the whole of their consideration in cash, instead of insisting that they should retain a share interest in the company's fortune.

The director is advised then to approach the general meeting in the spirit that he is meeting his fellow shareholders. He is not one of a party whose object is that of countering the enquiry of the shareholders with skill. The board must not be secretive or antagonistic. Frankness is the only policy. In this connection it should be remembered that needless reserve or the unnecessary baulking of questions will only cause the members and the Press to sift the matter to the bottom. The Press in particular will leave no stone unturned—and rightly, too—to provide information on points concerning which there is any appearance of anxiety to resist criticism.

The Speech. An examination of the reports of chairmen's speeches reveals the strange fact that many of them commence with a mass of uninteresting information concerning the accounts, which might well be left unsaid. The new director might advantageously consider these speeches, placing himself in the position of the enquiring shareholder, and endeavouring to find out the reason why the greater part of these orations are delivered at all. It is safe to say that in a large number of cases he will fail. By noting down carefully the type of information which does not enlighten him he will be able to avoid superfluity when preparing his own speeches later. He will find that the speeches consist, to a great extent, of comparison of figures appearing in the balance sheet with

the corresponding amounts of the previous year. He is first informed that the sundry creditors amount to "£101,362 4s. 9d. as against £110,696 5s. 2d. last year, a reduction of £9,334 0s. 5d. on the year." There may possibly be some motive underlying this information, but when it is remembered that the balance sheet just happens to show the position at a certain date, it is difficult to appreciate the reason for expatiating on "reductions of sundry creditors." It is quite possible that twelve hours before the closing of the accounts the sundry creditors were many thousands of pounds in excess of the amount appearing in the last balance sheet, and that the reduction upon which stress is laid merely resulted from the fact that the company's monthly pay-day occurred one day before the end of the year. Cash at bank is reported as "now standing at £65,220 as against £22,000 last year, an increase of £43,220." This useful information is also designed to enlighten the shareholder who draws some conclusion or other which may not be identical with that he would form if he knew, for instance, that a loan had just been made to the company and that the cash received was offset by a charge on the company's property concealed in one or other composite asset figures. It should not be necessary to bore shareholders with these and similar "explanations." If the directors are of opinion that the shareholders should be in possession of the knowledge required to appreciate variations in figures of assets or liabilities, then the disclosure should be made in the printed report. There is some ground for suspecting that information is given in speeches which materially affects the printed accounts. If the speeches are not afterwards published in order that the shareholders may study the exact effect at their leisure, then the explanations cannot be fully appreciated.

Form of Speech. Assuming that the accounts have been set out in sufficient detail to enable the shareholder to understand the form in which his property exists, then the speech should be framed to give—

(*a*) An outline of the company's activities during the past year.

(*b*) An account of improvements effected in the company's management and manufactures.

(*c*) A report on changes carried out in main policy.

(*d*) A statement of the company's trade, orders in hand and prospects for the ensuing year.

(*e*) Recommendations as to dividends and other appropriations of profit, supported by the foregoing portions of the speech.

Ample opportunity should be given to shareholders to ask questions upon matters arising out of the accounts or the speech. Answers to these questions should be given at the meeting itself, and any appearance of endeavouring to omit answering should be avoided. Occasionally, answers are not given at the meeting itself, the enquiring shareholder being requested to present himself at the company's office at a later date for the information he seeks. This artifice is a weak one and never engenders confidence. It must be remembered that a competitor may, by becoming a shareholder, place himself in a position to acquire any information not given openly at a meeting. Suspicion can be disarmed only by frankness.

The director concludes his replies to the enquiries of the shareholders by putting the question. The report and accounts are then either adopted or they are rejected. The chairman should be firm in the event of rejection and should rule out such resolutions as that " the report be received but not adopted " and

similar incorrect amendments. If the meeting will not adopt the accounts it will usually be found sufficient to agree to an informal investigation by a committee, and an adjournment. If the report and accounts are adopted, one of the directors moves the payment of any dividend recommended. Occasionally shareholders endeavour to procure the payment of a higher dividend than that recommended. If such an attempt is made the Articles should be consulted. Most Articles provide that no higher dividend than that recommended may be declared but that the shareholders may declare a lower one. If the Articles are silent then Table " A " makes a provision similar to that just outlined and the directors may rightly resist attempts to pass a higher dividend.

Election of Officers. The election of auditors should be left entirely to the shareholders, but the directors must remind the meeting that none but the retiring auditors may be elected unless previous notice has been given. The report generally informs the members which of the directors retire and whether those directors are willing to be re-elected. The actual election of the directors should also be left to the meeting. If any of the formal proposals of the directors as to these routine matters are questioned, the board must be careful to preserve the harmony of the meeting. The chairman should not demand a poll until he is obliged to do so, but he should readily assent to such a demand from a shareholder if the proposal appears to be supported by the meeting. In any case, it is fatal to reveal that over-worked weapon of a majority of proxies until all other attempts to preserve harmony have failed. Even when a demand for a poll has been agreed to, the chairman should hold back his proxies and adjourn the meeting until a later hour in the day—preferably until after lunch—

over which the heat of the meeting will probably subside. The poll will then be taken in accordance with the Articles and the proxies may be used without arousing the feeling of injury and injustice which may be inculcated by the unconsidered policy of holding them at the members' heads.

APPENDIX

Important Sections of the Companies (Consolidation) Act, 1908, and Table A

Sec. 26.—(1) Every company having a share capital shall once at least in every year make a list of all persons who, on the fourteenth day after the first or only ordinary general meeting in the year, are members of the company, and of all persons who have ceased to be members since the date of the last return or (in the case of the first return) of the incorporation of the company.

(2) The list must state the names, addresses, and occupations of all the past and present members therein mentioned, and the number of shares held by each of the existing members at the date of the return, specifying shares transferred since the date of the last return or (in the case of the first return) of the incorporation of the company by persons who are still members and have ceased to be members respectively and the dates of registration of the transfers, and must contain a summary distinguishing between shares issued for cash and shares issued as fully or partly paid up otherwise than in cash, and specifying the following particulars—

(*a*) The amount of the share capital of the company, and the number of the shares into which it is divided ;

(*b*) The number of shares taken from the commencement of the company up to the date of the return ;

(*c*) The amount called up on each share ;

(*d*) The total amount of calls received ;

(*e*) The total amount of calls unpaid ;

(*f*) The total amount of the sums (if any) paid by way of commission in respect of any shares or debentures, or allowed by way of discount in respect of any debentures, since the date of the last return ;

(*g*) The total number of shares forfeited ;

(*h*) The total amount of shares or stock for which share warrants are outstanding at the date of the return ;

(*i*) The total amount of share warrants issued and surrendered respectively since the date of the last return ;

(*k*) The number of shares or amount of stock comprised in each share warrant ;

(*l*) The names and addresses of the persons who at the date of the return are the directors of the company, or occupy the position of directors, by whatever name called ; and

(*m*) The total amount of debt due from the company in respect of all mortgages and charges which are required (or, in the case of a company registered in Scotland, which if the company had been registered in England, would be required) to be registered with the registrar of companies under this Act, or which would have been required so to be registered if created after the first day of July nineteen hundred and eight.

(3) The summary must also (except where the company is a private company) include a statement, made up to such date as may be specified in the statement, in the form of a balance sheet, audited by the company's auditors, and containing a summary of its share capital, its liabilities, and its assets, giving such particulars as will

disclose the general nature of those liabilities and assets, and how the values of the fixed assets have been arrived at, but the balance sheet need not include a statement of profit and loss.

(4) The above list and summary must be contained in a separate part of the register of members, and must be completed within seven days after the fourteenth day aforesaid and the company must forthwith forward to the registrar of companies a copy signed by the manager or by the secretary of the company.

(5) If a company makes default in complying with the requirements of this section it shall be liable to a fine not exceeding five pounds for every day during which the default continues, and every director and manager of the company who knowingly and wilfully authorizes or permits the default shall be liable to the like penalty.

Sec. 72.—(1) A person shall not be capable of being appointed director of a company by the articles, and shall not be named as a director or proposed director of a company in any prospectus issued by or on behalf of the company, or in any statement in lieu of prospectus filed by or on behalf of a company, unless, before the registration of the articles or the publication of the prospectus, or the filing of the statement in lieu of prospectus, as the case may be he has by himself or by his agent authorized in writing—

(i) Signed and filed with the registrar of companies a consent in writing to act as such director; and

(ii) Either signed the memorandum for a number of shares not less than his qualification (if any), or signed and filed with the registrar a contract in writing to take from the company and pay for his qualification shares (if any).

(2) On the application for registration of the memorandum and articles of a company the applicant shall deliver to the registrar a list of the persons who have consented to be directors of the company and if this list contains the name of any person who has not so consented the applicant shall be liable to a fine not exceeding fifty pounds.

(3) This section shall not apply to a private company nor to a prospectus issued by or on behalf of a company after the expiration of one year from the date at which the company is entitled to commence business.

Sec. 73.—(1) Without prejudice to the restrictions imposed by the last foregoing section, it shall be the duty of every director who is by the regulations of the company required to hold a specified share qualification, and who is not already qualified to obtain his qualification within two months after his appointment, or such shorter time as may be fixed by the regulations of the company.

(2) The office of director of a company shall be vacated, if the director does not within two months from the date of his appointment, or within such shorter time as may be fixed by the regulations of the company, obtain his qualification, or if after the expiration of such period or shorter time he ceases at any time to hold his qualification; and a person vacating office under this section shall be incapable of being re-appointed director of the company until he has obtained his qualification.

(3) If after the expiration of the said period or shorter time any unqualified person acts as a director of the company, he shall be liable to a fine not exceeding five pounds for every day between the

expiration of the said period or shorter times and the last day on which it is proved that he acted as a director.

Sec. 80.—(1) Every prospectus issued by or on behalf of a company or in relation to any intended company shall be dated, and that date shall, unless the contrary be proved, be taken as the date of publication of the prospectus.

(2) A copy of every prospectus, signed by every person who is named therein as a director or proposed director of the company, or by his agent authorized in writing, shall be filed for registration with the registrar of companies on or before the date of its publication, and no such prospectus shall be issued until a copy thereof has been so filed for registration.

(3) The registrar shall not register any prospectus unless it is dated, and the copy thereof signed, in manner required by this section.

(4) Every prospectus shall state on the face of it that a copy has been filed for registration as required by this section.

(5) If a prospectus is issued without a copy thereof being so filed, the company, and every person who is knowingly a party to the issue of the prospectus, shall be liable to a fine not exceeding five pounds for every day from the date of the issue of the prospectus until a copy thereof is so filed.

Sec. 81.—(1) Every prospectus issued by or on behalf of a company, or by or on behalf of any person who is or has been engaged or interested in the formation of the company, must state—

(*a*) The contents of the memorandum, with the names, descriptions, and addresses of the signatories, and the number of shares subscribed for by them respectively; and the number of founders or management or deferred shares, if any, and the nature and extent of the interest of the holders in the property and profits of the company; and

(*b*) The number of shares, if any, fixed by the Articles as the qualification of a director, and any provision in the Articles as to the remuneration of the directors; and

(*c*) The names, descriptions, and addresses of the directors or proposed directors; and

(*d*) The minimum subscription on which the directors may proceed to allotment, and the amount payable on application and allotment on each share; and in the case of a second or subsequent offer of shares, the amount offered for subscription on each previous allotment made within the two preceding years, and the amount actually allotted, and the amount, if any paid on the shares so allotted; and

(*e*) The number and amount of shares and debentures which within the two preceding years have been issued, or agreed to be issued, as fully or partly paid up otherwise than in cash, and in the latter case the extent to which they are so paid up, and in either case the consideration for which those shares or debentures have been issued or are proposed or intended to be issued; and

(*f*) The names and addresses of the vendors of any property purchased or acquired by the company, or proposed so to be purchased or acquired, which is to be paid for wholly or partly out of the proceeds of the issue offered for subscription by the prospectus, or the purchase or acquisition of which has not been

completed at the date of issue of the prospectus, and the amount payable in cash, shares, or debentures, to the vendor, and where there is more than one separate vendor, or the company is a sub-purchaser, the amount so payable to each vendor: Provided that where the vendors or any of them are a firm the members of the firm shall not be treated as separate vendors; and

(*g*) The amount (if any) paid or payable as purchase money in cash, shares, or debentures, for any such property as aforesaid, specifying the amount (if any) payable for goodwill; and

(*h*) The amount (if any) paid within the two preceding years, or payable, as commission for subscribing or agreeing to subscribe, or procuring or agreeing to procure subscriptions, for any shares in, or debentures of, the company, or the rate of any such commission: Provided that it shall not be necessary to state the commission payable to sub-underwriters; and

(*i*) The amount or estimated amount of preliminary expenses; and

(*j*) The amount paid within the two preceding years or intended to be paid to any promoter, and the consideration for any such payment; and

(*k*) The dates of and parties to every material contract, and a reasonable time and place at which any material contract or a copy thereof may be inspected: Provided that this requirement shall not apply to a contract entered into in the ordinary course of the business carried on or intended to be carried on by the company, or to any contract entered into more than two years before the date of issue of the prospectus; and

(*l*) The names and addresses of the auditors (if any) of the company; and

(*m*) Full particulars of the nature and extent of the interest (if any) of every director in the promotion of, or in the property proposed to be acquired by, the company, or, where the interest of such a director consists in being a partner in a firm, the nature and extent of interest of the firm, with a statement of all sums paid or agreed to be paid to him or to the firm in cash or shares or otherwise by any person either to induce him to become, or to qualify him as, a director, or, otherwise for services rendered by him or by the firm in connection with the promotion or formation of the company; and

(*n*) Where the company is a company having shares of more than one class, the right of voting at meetings of the company conferred by the several classes of shares respectively.

(2) For the purposes of this section every person shall be deemed to be a vendor who has entered into any contract, absolute or conditional, for the sale or purchase, or for any option of purchase, of any property to be acquired by the company, in any case where—

(*a*) The purchase money is not fully paid at the date of issue of the prospectus; or

(*b*) The purchase money is to be paid or satisfied wholly or in part out of the proceeds of the issue offered for subscription by the prospectus; or

(*c*) The contract depends for its validity or fulfilment on the result of that issue.

(3) Where any of the property to be acquired by the company

is to be taken on lease, this section shall apply as if the expression "vendor" included the lessor, and the expression "purchase money" included the consideration for the lease, and the expression "sub-purchaser" included a sub-lessee.

(4) Any condition requiring or binding any applicant for shares or debentures to waive compliance with any requirement of this section, or purporting to affect him with notice of any contract, document, or matter not specifically referred to in the prospectus shall be void.

(5) Where any such prospectus as is mentioned in this section is published as a newspaper advertisement, it shall not be necessary in the advertisement to specify the contents of the memorandum or the signatories thereto, and the number of shares subscribed for by them.

(6) In the event of non-compliance with any of the requirements of this section, a director or other person responsible for the prospectus shall not incur any liability by reason of the non-compliance, if he proves that—

(*a*) As regards any matter not disclosed, he was not cognizant thereof; or

(*b*) The non-compliance arose from an honest mistake of fact on his part:

Provided that in the event of non-compliance with the requirements contained in paragraph (*m*) of sub-section (1) of this section no director or other person shall incur any liability in respect of the non-compliance unless it be proved that he had knowledge of the matters not disclosed.

(7) This section shall not apply to a circular or notice inviting existing members or debenture holders of a company to subscribe either for shares or for debentures of the company, whether with or without the right to renounce in favour of other persons, but subject as aforesaid, this section shall apply to any prospectus whether issued on or with reference to the formation of a company or subsequently.

(8) The requirements of this section as to the Memorandum and the qualification, remuneration, and interest of directors, the names, descriptions, and addresses of directors or proposed directors, and the amount or estimated amount of preliminary expenses, shall not apply in the case of a prospectus issued more than one year after the date at which the company is entitled to commence business.

(9) Nothing in this section shall limit or diminish any liability which any person may incur under the general law or this Act apart from this section.

Sec. 84.—(1) Where a prospectus invites persons to subscribe for shares in or debentures of a company, every person who is a director of the company at the time of the issue of the prospectus, and every person who has authorized the naming of him and is named in the prospectus as a director or as having agreed to become a director either immediately or after an interval of time, and every promoter of the company, and every person who has authorized the issue of the prospectus, shall be liable to pay compensation to all persons who subscribe for any shares or debentures on the faith of the prospectus for the loss or damage they may have sustained

by reason of any untrue statement therein, or in any report or memorandum appearing on the face thereof, or by reference incorporated therein or issued therewith, unless it is proved—

(*a*) With respect to every untrue statement not purporting to be made on the authority of an expert, or of a public official document or statement, that he had reasonable ground to believe, and did up to the time of the allotment of the shares or debentures, as the case may be, believe, that the statement was true; and

(*b*) With respect to every untrue statement purporting to be a statement by or contained in what purports to be a copy of or extract from a report or valuation of an expert, that it fairly represented the statement, or was a correct and fair copy of or extract from the report or valuation. Provided that the director, person named as director, promoter, or person who authorized the issue of the prospectus, shall be liable to pay compensation as aforesaid if it is proved that he had no reasonable ground to believe that the person making the statement, report, or valuation was competent to make it; and

(*c*) With respect to every untrue statement purporting to be a statement made by an official person or contained in what purports to be a copy or extract from a public official document, that it was a correct and fair representation of the statement or copy of or extract from the document; or unless it is proved—

(i) That having consented to become a director of the company he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent; or

(ii) That the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue he forthwith gave reasonable public notice that it was issued without his knowledge or consent; or

(iii) That after the issue of prospectus and before allotment thereunder, he on becoming aware of any untrue statement therein, withdrew his consent thereto, and gave reasonable public notice of the withdrawal, and of the reason therefor.

(2) Where a company existing on the eighteenth day of August one thousand eight hundred and ninety, has issued shares or debentures, and for the purpose of obtaining further capital by subscriptions for shares or debentures issues a prospectus, a director shall not be liable in respect of any statement therein, unless he has authorized the issue of the prospectus, or has adopted or ratified it.

(3) Where the prospectus contains the name of a person as a director of the company, or as having agreed to become a director thereof, and he has not consented to become a director, or has withdrawn his consent before the issue of the prospectus, and has not authorized or consented to the issue thereof, the directors of the company, except any without whose knowledge or consent the prospectus was issued, and any other person who authorized the issue thereof, shall be liable to indemnify the person named as aforesaid against all damages, costs, and expenses to which he may be made liable by reason of his name having been inserted in the prospectus, or in defending himself against any action or legal proceedings brought against him in respect thereof.

(4) Every person who by reason of his being a director, or named as a director or as having agreed to become a director, or of his having authorized the issue of the prospectus, becomes liable to make any payment under this section may recover contribution, as in cases of contract, from any other person who, if sued separately would have been liable to make the same payment, unless the person who has become so liable was, and that other person was not, guilty of fraudulent misrepresentation.

(5) For the purposes of this section—

The expression " promoter " means a promoter who was a party to the preparation of the prospectus, or of the portion thereof containing the untrue statement, but does not include any person by reason of his acting in a professional capacity for persons engaged in procuring the formation of the company :

The expression " expert " includes engineer, valuer, accountant, and any other person whose profession gives authority to a statement made by him.

Sec. 85.—(1) No allotment shall be made of any share capital of a company offered to the public for subscription, unless the following conditions have been complied with, namely—

(*a*) The amount (if any) fixed by the memorandum or articles and named in the prospectus as the minimum subscription upon which the directors may proceed to allotment ; or

(*b*) If no amount is so fixed and named, then the whole amount of the share capital so offered for subscription, has been subscribed, and the sum payable on application for the amount so fixed and named, or for the whole amount offered for subscription, has been paid to and received by the company.

(2) The amount so fixed and named and the whole amount aforesaid shall be reckoned exclusively of any amount payable otherwise than in cash, and is in this Act referred to as the minimum subscription.

(3) The amount payable on application on each share shall not be less than five per cent of the nominal amount of the share.

(4) If the conditions aforesaid have not been complied with on the expiration of forty days after the first issue of the prospectus, all money received from applicants for shares shall be forthwith repaid to them without interest, and, if any such money is not so repaid within forty-eight days after the issue of the prospectus, the directors of the company shall be jointly and severally liable to repay that money with interest at the rate of five per centum per annum from the expiration of the forty-eighth day :

Provided that a director shall not be liable if he proves that the loss of the money was not due to any misconduct or negligence on his part.

(5) Any condition requiring or binding any applicant for shares to waive compliance with any requirement of this section shall be void.

(6) This section, except sub-section (3) thereof, shall not apply to any allotment of shares subsequent to the first allotment of shares offered to the public for subscription.

(7) In the case of the first allotment of share capital payable in case of a company which does not issue any invitation to the public

to subscribe for its shares, no allotment shall be made unless the minimum subscription (that is to say)—

(*a*) The amount (if any) fixed by the memorandum or articles and named in the statement in lieu of prospectus as the minimum subscription upon which the directors may proceed to allotment ; or

(*b*) If no amount is so fixed and named, then the whole amount of the share capital other than that issued or agreed to be issued as fully or partly paid up otherwise than in cash,

has been subscribed and an amount not less than five per cent of the nominal amount of each share payable in cash has been paid to and received by the company.

This sub-section shall not apply to a private company or to a company which has allotted any shares or debentures before the first day of July, nineteen hundred and eight.

Sec. 91.—Where any shares of a company are issued for the purpose of raising money to defray the expenses of the construction of any works or buildings or the provision of any plant which cannot be made profitable for a lengthened period, the company may pay interest on so much of that share capital as is for the time being paid up for the period and subject to the conditions and restrictions in this section mentioned, and may charge the same to capital as part of the cost of construction of the work or building, or the provision of plant :

Provided that—

(1) No such payment shall be made unless the same is authorized by the articles or by special resolution :

(2) No such payment, whether authorized by the articles or by special resolution, shall be made without the previous sanction of the Board of Trade :

(3) Before sanctioning any such payment the Board of Trade may, at the expense of the company, appoint a person to inquire and report to them as to the circumstances of the case, and may, before making the appointment, require the company to give security for the payment of the costs of the inquiry :

(4) The payment shall be made only for such period as may be determined by the Board of Trade ; and such period shall in no case extend beyond the close of the half year next after the half year during which the works or buildings have been actually completed or the plant provided :

(5) The rate of interest shall in no case exceed four per cent per annum or such lower rate as may for the time being be prescribed by Order in Council :

(6) The payment of the interest shall not operate as a reduction of the amount paid up on the shares in respect of which it is paid :

(7) The accounts of the company shall show the share capital on which, and the rate at which, interest has been paid out of capital during the period to which the accounts relate :

(8) Nothing in this section shall affect any company to which the Indian Railways Act, 1894, as amended by any subsequent enactment, applies.

Sec. 192.—(1) Where a company is proposed to be, or is in course of being, wound up altogether voluntarily, and the whole or part of its business or property is proposed to be transferred or

sold to another company (in this section called the transferee company), the liquidator of the first-mentioned company (in this section called the transferor company), may, with the sanction of a special resolution of that company, conferring either a general authority on the liquidator or an authority in respect of any particular arrangement, receive in compensation or part compensation for the transfer or sale, shares, policies, or other like interests in the transferee company, for distribution among the members of the transferor company, or may enter into any other arrangement whereby the members of the transferor company may, in lieu of receiving cash, shares, policies, or other like interests, or in addition thereto, participate in the profits of or receive any other benefit from the transferee company.

(2) Any sale or arrangement in pursuance of this section shall be binding on the members of the transferor company.

(3) If any member of the transferor company who did not vote in favour of the special resolution at either of the meetings held for passing and confirming the same expresses his dissent therefrom in writing addressed to the liquidator, and left at the registered office of the company within seven days after the confirmation of the resolution, he may require the liquidator either to abstain from carrying the resolution into effect, or to purchase his interest at a price to be determined by agreement or by arbitration in manner provided by this section.

(4) If the liquidator elects to purchase the member's interest, the purchase money must be paid before the company is dissolved, and be raised by the liquidator in such a manner as may be determined by special resolution.

(5) A special resolution shall not be invalid for the purpose of this section by reason that it is passed before or concurrently with a resolution for winding up the company, or for appointing liquidators; but, if an order is made within a year for winding up the company by or subject to the supervision of the court, the special resolution shall not be valid unless sanctioned by the court.

(6) For the purposes of an arbitration under this section the provisions of the Companies Clauses Consolidation Act, 1845, or, in the case of a winding up in Scotland, The Companies Clauses Consolidation (Scotland) Act, 1845, with respect to the settlement of disputes by arbitration, shall be incorporated with this Act; and in the construction of those provisions this Act shall be deemed to be the special Act, and "the company" shall mean the transferor company, and any appointment by the said incorporated provisions directed to be made under the hand of the secretary, or any two of the directors, may be made under the hand of the liquidator, or, if there is more than one liquidator, then of any two or more of the liquidators.

Sec. 215.—(1) Where in the course of winding up a company it appears that any person who has taken part in the formation or promotion of the company, or any past or present director, manager, or liquidator, or any officer of the company, has misapplied or retained or become liable or accountable for any money or property of the company, or has been guilty of any misfeasance or breach of trust in relation to the company, the court may, on the application of the official receiver, or of the liquidator, or of any creditor or

contributory, examine into the conduct of the promoter, director, manager, liquidator, or officer, and compel him to repay or restore the money or property or any part thereof respectively with interest at such a rate as the court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance, or breach of trust as the court thinks just.

(2) This section shall apply notwithstanding that the offence is one for which the offender may be criminally responsible.

(3) Where in the case of a winding up in England an order for payment of money is made under this section, the order shall be deemed to be a final judgment within the meaning of paragraph (*g*) of sub-section (1) of section four of the Bankruptcy Act, 1883.

(4) So much of this section as refers to promoters, and to property of a company other than money, shall not apply to a winding up in Scotland or Ireland.

Sec. 285. In this Act, unless the context otherwise requires, the following expressions have the meanings hereby assigned to them (that is to say)—

" Existing company " means a company formed and registered under the Joint Stock Companies Acts, or under the Companies Act, 1862 ;

" Company " means a company formed and registered under this Act, or an existing company.

" Articles " means the articles of association of a company, as originally framed or as altered by special resolution, including, so far as they apply to the company, the regulations contained (as the case may be) in Table B in the Schedule annexed to the Joint Stock Companies Act, 1856, or in Table A in the First Schedule annexed to the Companies Act, 1862, or in that Table as altered in pursuance of section seventy-one of that Act, or in Table A in the First Schedule to this Act ;

" Memorandum " means the memorandum of association of a company, as originally framed or as altered in pursuance of the provisions of this Act ;

" Document " includes summons, notice, order, and other legal process, and registers ;

" Share " means share in the share capital of the company, and includes stock except where a distinction between stock and shares is expressed or implied ;

" Debenture " includes debenture stock ;

" Books and papers " and " books or papers " include accounts, deeds, writings, and documents ;

" The registrar of companies " or, when used in relation to registration of companies, " the registrar," means the registrar or other officer performing under this Act the duty of registration of companies in England, Scotland, or Ireland, or in the stannaries as the case requires ;

" The court " used in relation to a company means the court having jurisdiction to wind up the company ;

" Joint Stock Companies Acts " means the Joint Stock Companies Act, 1856, the Joint Stock Companies Acts, 1856, 1857, the Joint Stock Banking Companies Act, 1857, and the Act to enable Joint Stock Banking Companies to be formed on the principle of limited

liability, or any one or more of those Acts, as the case may require ; but does not include the Act passed in the eighth year of the reign of Her Majesty Queen Victoria, chapter one hundred and ten, intituled An Act for the Registration, Incorporation, and Regulation of Joint Stock Companies ;

"The Gazette" means, as respects companies registered in England, the London Gazette ; as respects companies registered in Scotland, the Edinburgh Gazette, and as respects companies registered in Ireland, the Dublin Gazette ;

"Real and personal," as respects Scotland, means heritable and moveable ;

"General rules" means general rules made under this Act, and includes forms ;

"Prescribed" means, as respects the provisions of this Act relating to the winding up of companies, prescribed by general rules, and as respects the other provisions of this Act, prescribed by the Board of Trade ;

"Company within the stannaries" means a company engaged in or formed for working mines within the stannaries ;

"The court exercising the stannaries jurisdiction" used in relation to any proceedings means the county court in which the jurisdiction formerly exercised by the court of vice-warden of the stannaries in respect of those proceedings is for the time being vested ;

"Director" includes any person occupying the position of director by whatever name called ;

"Prospectus" means any prospectus, notice, circular, advertisement, or other invitation, offering to the public for subscription or purchase any shares or debentures of a company.

TABLE "A"

Clause 88. The quorum necessary for the transaction of the business of the directors may be fixed by the directors, and unless so fixed shall (when the number of directors exceeds three) be three.

Clause 91. The directors may delegate any of their powers to committees consisting of such member or members of their body as they think fit ; any committee so formed shall, in the exercise of the powers so delegated, conform to any regulations that may be imposed on them by the directors.

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Textile Bleaching
Timber
Tobacco
Velvet and Corduroy
Wallpaper
Weaving
Wheat
Wine and the Wine Trade
Wool
Worsted
Zinc

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